1982

Proposed audit guide : audits of brokers and dealers in securities ;Audits of brokers and dealers in securities; Exposure draft (American Institute of Certified Public Accountants), 1982, Dec. 27

American Institute of Certified Public Accountants. Stockbrokerage Auditing Subcommittee

EXPOSURE DRAFT

PROPOSED AUDIT GUIDE

AUDITS OF BROKERS AND DEALERS IN SECURITIES

DECEMBER 27, 1982

Prepared by the Stockbrokerage Auditing Subcommittee of the American Institute of Certified Public Accountants

Comments should be received by March 28, 1983, and addressed to file 8110, AICPA, 1211 Avenue of the Americas, New York, New York 10036

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AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 27, 1982

An exposure draft of a proposed AICPA audit guide, Audits of Brokers and Dealers in Securities, accompanies this letter. This exposure draft is a proposed revision of the 1973 AICPA industry audit guide, Audits of Brokers and Dealers in Securities, that was amended by the 1976 SOP of the same title. A summary of the proposed guide also accompanies this letter.

The FASB has issued FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters, which designates specialized accounting and reporting principles and practices contained in enumerated statements of position and AICPA Guides on Accounting and Auditing Matters as preferable accounting principles for purposes of applying APB Opinion No. 20, Accounting Changes. Paragraph 9 of the FASB statement concerns AICPA projects that are expected to result in the issuance of guides or statements of position that are listed in Appendix B of the FASB Statement. That paragraph states, "The Board plans to review any specialized principles and practices contained in any such SOPs and Guides before issuance and, if the Board finds them acceptable, it will, after appropriate due process, issue Interpretations of this (FASB) Statement announcing that they are preferable accounting principles for purposes of applying Opinion 20."

The accompanying exposure draft is one of the items listed in Appendix B as one of the AICPA projects that the FASB plans to review for designation by interpretation as preferable accounting principles for purposes of applying APB Opinion No. 20.

Comments received by the AICPA will be considered by the FASB when it reviews the final Guide to determine whether to designate as preferable the specialized accounting principles and practices in the Guide.

Commentators on the proposed guide are specifically requested to give particular attention to the prohibition against the current industry practice of combining subordinated debt and stockholders' equity on the statement of financial condition. Paragraph 146 states, "Subordinated debt and stockholders' equity (or partners' capital) should be classified separately. It is not permissible to present a combination of subordinated liabilities and stockholders' equity (or partners' capital) regardless of the disclosure of the components or the use of descriptive captive titles."

The Securities and Exchange Commission's Accounting Series Release No. 118, "Accounting for Investment Securities by Regulated Investment Companies," allows the "subject to" form of report when management has valued securities for which market quotations are not readily available and when the auditor is satisfied that the procedures followed and the information obtained is adequate to enable management to value the securities, but the auditor is unable to form an opinion as to management's valuation. Although at present, the SEC accepts such a report on the financial statements of a broker or dealer in similar circumstances and does not accept any other form of qualified opinion in such instances, those circumstances do not constitute an uncertainty as described in SAS No. 2, "Reports on Audited Financial Statements." The proposed guide gives an example of an audit opinion qualified for a scope limitation that is appropriate for such circumstances. Commentators on the proposed guide are specifically requested to give particular attention to this matter.

Comments or suggestions on issues contained in the exposure draft will be appreciated. The subcommittee's consideration of responses will be helped if comments refer to a specific paragraph, explain the problem, and include supporting reasons for any suggestions or comments.

In developing guidance, the AICPA Auditing Standards Division considers the relationship between the cost imposed and the benefits reasonably expected to be derived from services rendered by accountants. It also considers differences that may be encountered in rendering such services to small organizations and, when appropriate, makes special provisions to meet those needs. Thus, the subcommittee would particularly appreciate comments on those matters.

Responses should be addressed to the AICPA Auditing Standards Division, File 8110, in time to be received by March 28, 1983. Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after April 11, 1983, for one year.

Sincerely,

Gerard Marcus
Chairman
Stockbrokerage Auditing Subcommittee

D. R. Carmichael
Vice President, Auditing

This exposure draft has been sent to

- *selected brokerage industry accounting groups*
- *members of AICPA Council and technical committee chairmen*
- *state society and chapter presidents, directors, and committee chairmen*
- *organizations concerned with regulatory, supervisory, or other public disclosure of financial activities*
- *persons who have requested copies*

SUMMARY

This proposed revised audit guide on brokers and dealers in securities was undertaken to reflect changes in industry practices and regulatory requirements that have occurred in recent years. The proposed guide describes operations, accounting practices and regulatory requirements unique to the brokerage industry, discusses unique aspects of the audit and illustrates the form and content of the financial statements and auditor's report. Also, the draft recommends new accounting and reporting practices relating to the valuation of future and forward transactions and unlisted options and to the presentation of subordinated debt and shareholders' equity in the financial statements.

Significant changes in the guide are:

- Discussion of the SEC's adoption of the FOCUS Report, which replaced the "Answers to Financial Questionnaire" with GAAP financial statements.

- Prohibition against the combination of subordinated debt and shareholders' equity in the statement of financial condition.

- An explanation of how to meet the SEC's requirements for a review of and report on internal accounting control and also meet the standards of SAS No. 30, "Reporting on Internal Accounting Control," and presentation of illustrative reports.

- A new chapter discussing government and money market instruments, and a recommendation that all future and forward transactions should be marked-to-market currently, with the effect recorded in current results of operations. Also, the guide states that the gross amounts of future and forward commitments should be disclosed in the notes to financial statements rather than recording the future assets and liabilities.

- Expanded discussion of listed options and a recommendation that unlisted options should be valued at fair value, as listed options currently are valued.

- A discussion of the Commodity Futures Trading Commission in the chapter on commodities.

- Presentation of illustrative financial statements and schedules that conform to the FOCUS reporting requirements and other SEC rules.

- Illustrative auditors' reports on the financial statements and schedules that conform to the reporting guidance in SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents."

- Illustrative auditor's report qualified for a scope limitation, appropriate if the financial statements include securities valued by management and the auditor believes that, although the valuation procedures appear reasonable and the underlying documentation appropriate, the determination of fair value involves subjective judgment that is not susceptible to substantiation by auditing procedures.

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PREFACE

This audit and accounting guide has been prepared to assist the independent auditor in conducting examinations of financial statements of brokers and dealers in securities. It describes the conditions or procedures unique to the industry and illustrates the form and content of broker or dealer financial statements and related informative disclosures. Included are a discussion of brokerage transactions, accounting records, internal accounting controls and procedures for safeguarding securities, unique aspects of the examination, and illustrations of various financial statements and independent auditors' reports.

The form of financial reporting of brokers or dealers, in accordance with requirements established by the regulatory or self-regulatory bodies, is intended to meet the needs of customers who do business with these securities concerns; the regulatory bodies and lenders; and, in the case of firms with public ownership, the needs of stockholders.

Most brokers and dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Those that are members of the National Association of Securities Dealers Inc. (NASD) are subject to the rules of that association, and those that are members of securities or commodities exchanges are also subject to the rules of such exchanges. Some of these rules, as currently in effect, are discussed in this guide. However, changes in the rules, regulations, practices and procedures of the securities industry have been frequent and extensive in recent years. Still further changes are under consideration as this guide goes to press, and the independent auditor should keep abreast of these changes.

This publication is only a guide in determining the scope of the work for each individual audit. It is not intended to limit or supplant individual judgment, initiative, imagination, and vigilance. Programs for each audit should be designed to meet the requirements of the particular situation, giving careful consideration to the size and type of organization and the system of internal accounting control; this is a matter that should be determined by the exercise of professional judgment in light of circumstances present in a particular case.

Stockbrokerage Auditing Subcommittee

TRANSITION

Generally accepted accounting principles and generally accepted auditing standards, as they pertain to business entities in general, are applicable to brokers or dealers in securities. Accordingly, the accounting principles established by pronouncements of the Financial Accounting Standards Board and its predecessor bodies of the American Institute of Certified Public Accountants are applicable to brokers or dealers in securities. The accounting provisions of this guide, except for the accounting for all future and forward transactions, are effective upon issuance.

Specific guidance on the accounting by brokers and dealers in securities for all future and forward transactions had not been established prior to the issuance of this guide. This guide now establishes that all future and forward transactions should be marked to market currently, with the effect recorded in the statement of income. The gross amounts of such future and forward commitments should be disclosed in the notes to the financial statements of brokers or dealers in securities for fiscal periods beginning after (Date). Earlier application, however, is encouraged.

A change in accounting principles resulting from the adoption of the new treatment for all future and forward transactions shall be reported in accordance with the special provisions of paragraphs 27-28 of APB Opinion no. 20, Accounting Changes. Accordingly, adjustments resulting from a change in accounting method to comply with the recommendation in this guide should be applied retroactively, if material. And, to enhance comparability between periods, financial statements presented for prior periods affected should be restated to the extent practicable to give retroactive effect to such adjustments. If retroactive restatement of all years presented is not practicable, the financial statements presented should be restated for as many consecutive years as practicable and the cumulative effect of applying the change should be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect should be included in net income in the year the new treatment is first adopted. (Refer to paragraph 20 of APB Opinion no. 20.) The effect on revenues, income before extraordinary items, net income and related per share amounts of applying the new treatment in a year in which the cumulative effect is included in determining that year's net income should be disclosed for that year.

CHAPTER 1

GENERAL

Introduction

1. A securities broker or dealer engages in various functions within the securities industry. As a broker (in an agency capacity) it buys and sells securities or commodities for its customers and charges a commission, and as a dealer or trader (in a principal capacity) it buys and sells for its own account (trading with customers or other dealers).

2. Although the buying, selling, and settling of accounts are usually relatively simple in other industries, those functions by brokers or dealers in securities may be complicated by many intermediate steps that occur between the receipt of an order and the completion of a buy or sell transaction.

3. In addition to buying and selling securities and commodities, a securities broker or dealer may underwrite or participate in the underwriting of securities, assist in the private placement of securities, offer investment advisory services, extend credit to customers who have purchased securities on margin, and act as a depository in holding securities owned by its customers. A securities broker or dealer may market investments such as oil and gas and real estate participations, livestock programs, and equipment leasing ventures--all of which are highly specialized investment activities.

Rules Applicable to Brokers or Dealers in Securities

4. Brokers or dealers in securities are regulated primarily by the Securities Exchange Act of 1934 (the '34 act). The principal purpose of that act is to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate, foreign and through-the-mail commerce to prevent inequitable and unfair practices on such exchanges and markets.

5. The Securities and Exchange Commission (SEC) in recent years has greatly expanded its involvement in broker and dealer activities in an effort to have all brokers or dealers operate under uniform rules. Certain rules under the '34 act have been revised, and a number of interpretations of the rules have been issued.

6. The Securities Act Amendments of 1975, among other matters, made it necessary for municipal securities dealers to register with and come under the regulatory authority of the SEC. The municipal dealers industry, working with the SEC, established the Municipal Securities Rulemaking Board (MSRB) which has the primary rulemaking authority, subject to SEC oversight, for securities dealers whose only transactions are in municipal securities.

7. Independent auditors should be familiar with the following rules of the SEC:

- o 8c-1 and 15c-2 concerning fraudulent practices and hypothecation of customers' securities
- o 15c3-1 regarding the uniform net capital rule
- o 15c3-3 concerning the maintenance of a reserve bank account for the exclusive benefit of customers and the requirement to obtain possession or control of customers' fully paid and excess margin securities
- o 17a-3 regarding records to be maintained
- o 17a-4 describing retention of records
- o 17a-5 concerning auditing and reporting requirements
- o 17a-11 involving notification concerning violations of SEC rules
- o 17a-13 concerning quarterly security counts, verifications and comparisons

8. In addition to a familiarity with those rules of the SEC, the independent auditor should be familiar with regulations G, T, U, and X of the Board of Governors of the Federal Reserve System and, if the client is a member of a securities exchange or the NASD, with the pertinent rules of those organizations. Rule 431 of the New York Stock Exchange concerning margin accounts and transactions is of particular importance. The independent auditor should also review the applicable financial reporting releases, accounting series releases and other releases that are published by the SEC.

9. Effective January 1, 1976, the SEC amended rule 17a-5 and adopted a new financial and operational reporting system for brokers or dealers in securities. The new reporting system, Financial and Operational Combined Uniform Single Report (FOCUS), was designed to eliminate duplicate reporting of information to the SEC and self-regulatory organizations. The FOCUS report supersedes the previous Forms X-17A-5 and X-17A-11, the Joint Regulatory Report, the NASD Forms M and Q, and various other financial and operational forms and reports previously required by self-regulatory organizations. It allows brokers or dealers to file one series of reports monthly or quarterly, depending on their type of business.

10. Under rule 17a-5, an independent auditor is to report on the financial statements prepared in conformity with generally accepted accounting principles. Since the broker or dealer operates in a fiduciary capacity, financial stability is considered to be of utmost importance. For this reason, emphasis is placed on the protection afforded customers who entrust money and securities to a broker or dealer. Thus, the independent auditor also is to report on supplementary schedules required by rule 17a-5 involving computation of net capital pursuant to rule 15c3-1, computation for determination of the

reserve requirements pursuant to exhibit A of rule 15c3-3, and information relating to the possession or control requirements pursuant to rule 15c3-3. As part of the annual audit the independent auditor also must prepare reports on internal accounting control required by SEC rule 17a-5 and Regulation 1.16 of the Commodities Exchange Act.

11. In 1975 the SEC adopted the uniform net capital rule (rule 15c3-1) for all brokers or dealers, including members of certain designated national securities exchanges who previously complied with the net capital rule of such exchanges and who were therefore exempt from the SEC rule. This rule established certain minimum capital requirements and introduced an alternative net capital concept. In addition, the rule established debt-equity requirements, criteria for satisfactory subordination agreements, and requirements relating to the consolidation of certain subsidiaries and affiliates for net capital purposes. The rule became applicable to certain brokers or dealers, such as municipal security dealers not previously covered by the prior net capital rules, and to certain registered traders and floor brokers.

12. As a means of increasing net capital, brokers or dealers frequently borrow cash or securities under agreements that subordinate such borrowings to claims of general creditors. Such subordinated borrowings, if approved by the designated examining authority, are includible as part of net capital under the net capital rules. The SEC has set forth criteria for such borrowings to qualify as net capital and has established the abovementioned maximum debt-equity ratio.

13. The Securities Investor Protection Act of 1970, which established the Securities Investor Protection Corporation (SIPC), requires registered brokers or dealers, with few exceptions, to become members of SIPC and therefore subject to an annual fee assessment. The act provides the SEC with rulemaking authority relating to the custody and use of customers' securities, and to the carrying and use of customers' funds (credit balances). The act also requires establishment of rules regarding the maintenance of reserves relating to customers' funds. Exercise of this authority led to the SEC's implementation of rule 15c3-3.

14. The language of the securities industry includes many specialized terms. (A glossary of those frequently encountered is included in this guide.) Familiarity with these terms is essential to the independent auditor contemplating an examination of a broker or dealer.

Brokerage Transactions

15. Transactions Executed on an Exchange. Transactions in securities executed on an exchange may be in round lots (unit of trading that is normally 100 shares as specified by the exchange that lists the security) or in odd lots (quantities less than one unit of trading).

16. Transactions in securities executed on an exchange are normally initiated by a customer communicating with a registered representative (salesperson or account executive) to request that a specified number of shares

of a particular security be bought or sold at a stated price or at the current market price. Such an order is then usually communicated to the order room of the broker or dealer and then to its clerk who is stationed at one of the exchanges that trades the security. If the broker or dealer is not a member of the particular exchange or has no member on the floor, the order is relayed to a correspondent broker who executes the trade on the exchange.

17. In either case the order, once conveyed to the floor of the exchange, is given by the order clerk to a representative who will attempt to execute it. Once executed, the details of the transaction (price, quantity, other broker with whom the transaction was consummated, and so forth) are reported back to the order room of the broker or dealer for transmission of the data to its purchase and sales department. A confirmation of the trade is then prepared and sent to the customer.

18. Many of the exchanges have related clearing organizations. If a broker or dealer is a member, deliveries or receipts of securities and the related cash settlements are made through these clearing organizations. The clearing organization usually offsets transactions between members so that only the net transactions of a member require the physical movement of cash or securities each day. Most clearing organizations follow the practice of continuous net settlement, whereby the results of each day's transactions of a broker or dealer are netted against the prior day's balances. Brokers or dealers operating through correspondent brokers settle their transactions through these correspondent (clearing) brokers who in turn settle the transactions through the clearing organizations.

19. <u>Transactions Executed Over-the-Counter</u>. An offer to buy or sell an unlisted security may be executed by a broker or dealer entering into a transaction with another broker or dealer who makes a market in that security. Such transactions are executed and settled directly between the brokers or dealers, or are cleared through a clearing organization.

20. In the case of unlisted securities and new issues, the broker or dealer may act for its own account (as principal) in a purchase or sale transaction with a customer or another broker or dealer. No commission is reflected on this type of transaction; instead, the broker or dealer realizes a profit or loss on the purchase or sale of securities.

21. <u>Margin Transactions</u>. Margin transactions relate to the purchase or sale of securities on other than cash settlement terms. A purchase on margin contemplates an extension of credit to the customer by the broker or dealer. The maximum amount of such credit is prescribed by regulation T of the Board of Governors of the Federal Reserve System. If a broker or dealer borrows additional funds to make payment, it may pledge as collateral the securities purchased or other securities that it may rightfully hypothecate for such customers.

22. Additional margin deposits may be required (maintenance margin) if market fluctuations adversely affect the equity in the customer's account. Maintenance margin ordinarily is governed by the rules of the self-regulatory agencies (for example, rule 431 of the New York Stock Exchange) of which the

broker or dealer is a member rather than by regulation T. However, many brokers or dealers have self-imposed margin requirements that are more stringent than exchange requirements.

23. Option Transactions. Options (referred to as "puts" and "calls") give the holder the right to sell or buy a specified number of shares of stock (normally 100 shares) at a specified price within a specified time. A put option gives the holder the right to sell the stock; a call option gives the holder the right to buy the stock. A put option obligates the seller of the option to take delivery of the stock and pay the specified price to the owner of the option within the time limit of the option. A call option obligates the seller of the option to deliver the stock to the buyer of the option at the specified price within the time limit of the option, if the option is exercised.

24. Listed options have gained wide recognition and are traded actively on several exchanges. Unlisted options have been infrequently written and sold since trading in listed options began; those that are written and sold are customarily handled through the auspices of the National Put and Call Association. Whether an option is exercised obviously depends on market conditions. Exchange-traded (listed) options are exercised less frequently than unlisted options because the purchaser or writer of listed options has the ability to enter into a closing or contra transaction. (Listed and unlisted option transactions are discussed in Chapter 6 of this guide, "Option Transactions.")

25. Arbitrage Transactions. The common definition of arbitrage is "the simultaneous purchase and sale of the same or equivalent security in order to profit from price discrepancies." Although the definition is by no means inaccurate, it is incomplete in today's securities market. There are two broad categories of arbitrage: basic or riskless arbitrage and risk arbitrage.

26. One type of basic arbitrage involves the purchase of a security in one market and the simultaneous sale of the identical security, at a profit, in another market. The price difference is normally not large and the risk is minimal. Another type of basic arbitrage is the purchase and sale of similar securities in like markets. Convertibles and when-issued securities are of prime interest to the arbitrageur.

27. Risk arbitrage is based on activities such as mergers, reorganizations, recapitalizations, tenders for cash, and tenders for securities.

28. Mergers--The greatest opportunity for arbitrage profit is in the merger field. The reasons for the opportunity involve the uncertainty of successful consummation and the complicated proceedings necessary to finally complete a proposed merger. Although the majority of all proposed mergers are consummated, nevertheless, concentrated arbitrage positions in unsuccessful mergers can result in estimated losses.

29. Reorganization--Although reorganizations have historically been lucrative as a form of arbitrage, the number of reorganizations in recent years have been limited, occurring only in the event of bankruptcy or when the avoidance of bankruptcy is necessary. A reorganization in its most common form

usually calls for the issuance of securities junior to the senior security holders and perhaps an elimination of the position of the common stockholders.

30. Recapitalizations--Recapitalizations are also limited at the present time. In the past, they were largely confined to public utilities. They generally include exchanges of debt for preferred stock and adjustments of arrearages on preferred stock by the issuance of debentures, arrear certificates or common shares.

31. Tenders for cash--In the usual tender for cash, a corporation makes an offer for a specific minimum number of shares of another company, reserving the option to accept all stock tendered over the minimum as well as a lesser number of shares. The tender price is usually substantially above the current market price, and the arbitrageur must evaluate the risk of not having any or all the shares accepted.

32. Tenders for securities--Another type of tender is the offering of specific securities and cash in exchange for the securities of another corporation. The amount of tendered shares may be limited; in addition, certain market valuations are usually placed on the shares being offered. If there is a material change in market value from the time the tender offer is proposed to the effective date, changes can be made in the number of shares exchanged or the corporation making the tender may withdraw.

33. Underwriting Transactions. Corporations and governmental divisions that desire to raise funds through the sale of securities normally engage securities brokers or dealers to underwrite the security issues on either a "firm commitment" or a "best efforts" basis. An underwriting group may also be formed on a "standby basis" (commitment to purchase the securities, if called on). When the transaction is on a firm commitment basis, the underwriter (or underwriters) agrees to purchase the entire security issue from the issuer for a specified price and then proceeds to sell the securities to the public at a slightly higher price. On a best efforts underwriting, the underwriter agrees to sell as much of the issue as he can, normally with a minimum requirement to complete the underwriting.

34. Since the value of most new issues of securities and the liability for successful marketing are normally too great for any one broker or dealer to assume, group accounts or syndicates may be formed in order to spread the risk. Additionally, selling groups, which may include brokers or dealers other than members of the underwriting group, are sometimes formed in order to obtain wider geographical distribution of the new issue.

35. The liability of the underwriting group may be divided or undivided. If the liability is divided, each member of the group has a specified maximum liability to purchase a certain number of shares of stock or principal amount of bonds. If the liability is undivided, each member of the underwriting group has a designated percentage liability for unsold securities in the underwriting account.

36. Private Placements. Brokers or dealers may also arrange the private placement of securities by issuers. A private placement does not involve a

public offering and is not required to be the subject of a registration statement filed with the SEC. The securities involved in private placements can be either an initial issuance or a resale of previously issued securities that generally are restricted as to subsequent sale. For example, they may require registration under state and federal securities laws. The company's history, size, stability, and cash needs are factors in determining when the use of a private placement of debt or equity securities might be preferable to registering securities for sale to the public. In many instances, the expertise of the broker or dealer may be essential in analyzing the company's activities and requirements in order to determine the type of securities to be offered and to assist in structuring the placement to enhance marketability. Private placements are often conducted on a "best efforts" basis by a broker or dealer, with maximum consideration normally given to locating a relatively small group of investors whose investment objectives closely parallel the expectations of the issuer.

37. Tax-Sheltered Investments. Brokers and dealers may also offer both public and private tax-sheltered programs. These investments are offered in a wide range of businesses and products, but common to all are the flow-through tax benefits inherent in the investment. Although the common investment vehicle for these programs has been the limited partnership, other legal forms have also been used. These investments are normally considered "securities" and may require registration under federal and state securities laws.

38. "When-Issued" Transactions. "When-issued" transactions are contracts to purchase or sell securities only when, as, and if new securities are issued. Brokers and dealers enter into such purchase or sale transactions on pending issues of new securities. (These may arise through underwritings, exchanges, mergers and so forth, after preliminary agreement to issue the securities is established but before a date for settlement has been set.)

39. Delayed Delivery Transactions. Delayed delivery transactions are transactions by the broker or dealer for the purchase or sale of securities. They are similar in all respects to regular-way transactions (normal settlement) except that, by agreement, the date of consummation or settlement is extended.

40. Repurchase Transactions. A repurchase transaction, commonly known as a repo transaction, is a sale of a security coupled with an agreement by the seller to repurchase the security at a stated price which is generally the original sale price. Repurchase transactions may be made on either an overnight or fixed maturity basis, or made with an agreement for the dealer to buy back the security at an open date to be decided by the buyer and seller. A repo is not treated as a sale, even though the confirmation will read that the transaction is a sale subject to an agreement to repurchase the same or substantially identical securities. Securities owned that are sold by the broker or dealer subject to a repurchase agreement are treated as financing transactions and not as sales of trading or investment positions. Therefore, they should be reported with trading and investment accounts, at market value, with the amount of the repurchase agreement reflected as a liability. Although the buyer receives many of the incidences of ownership of the securities, he is not entitled to the interest rate on the security; instead, he receives interest on the amount of dollars advanced for the purchase of those securities at a rate negotiated with the seller.

41. A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the security at a definite price at a specific future date. For financial reporting purposes the transaction involving the same or substantially identical securities is treated as a receivable collateralized by the security purchased, not as part of the buyer's trading or investment account.

42. A matched repurchase agreement occurs when a dealer buys a reverse repurchase agreement and simultaneously or shortly thereafter matches it with a repurchase agreement. The dealer makes a profit on the difference between the interest charged on the repurchase agreement and the interest earned on the reverse repurchase agreement. Matched repos may be executed for equal or differing amounts, with the dealer receiving more funds from the buyer than the amount being loaned to the seller. For financial reporting purposes, matched repurchase transactions should be recorded as both assets and liabilities on the statement of financial condition. Brokers or dealers may wish to disclose in the notes to financial statements the amounts of such matched repurchase agreements included in the statement of financial condition.

43. Government bond dealers who have large inventories to be financed find it advantageous to execute repos with institutional investors because a repurchase transaction usually has a lower interest rate than the government dealer loan interest rate. By using repurchase agreements, investors are able, with negligible market risk, to earn interest on their balances. The principal risk to the purchaser is the credit worthiness of the debtor.

44. Mutual Funds. Many brokers or dealers offer their customers the opportunity to invest in mutual funds on an agency basis. Brokers act as agents for their customers by placing orders with the mutual funds. They may become involved in transmitting funds and, in the case of shares issued in certificate form, in providing safekeeping. However, orders with mutual funds are often placed in the customers' names, the shares are held by the funds' custodians, and the broker's or dealer's only financial involvement is through receipt of commission checks if orders are placed with funds that charge commissions ("load" funds). Brokers offer another service--that is, assistance in the redemption of mutual fund investments owned by customers. Both the purchase and redemption procedures are often simplified by the absence of certificates (uncertificated or "book" shares) reflecting the ownership of shares. Mutual funds or their transfer agents keep records of individual share ownership, including additions for the reinvestment of dividends and capital gains. Thus, certificates are not automatically prepared at the times of purchase but rather on request only, such as when a customer wishes to have a certificate reflecting ownership for collateral for a personal loan.

45. Refunding Governmental Bond Underwritings. A common type of underwriting involves the sale of bonds by a political subdivision, which uses the proceeds of the sale to retire an existing bond issue. A primary reason for the issuance of refunding bonds is to lower the effective cost to the political subdivision of carrying the debt. This is accomplished by investing the proceeds of the sale of the refunding bonds in high yield U.S. Government securities that are placed in an irrevocable escrow and are scheduled to pay interest and to mature at such times as to make possible the retirement of

principal and interest on the initial bond issue. Thus, through a combination of possible lower interest rates on the refunding bonds and the high rate of yield on the U.S. Government securities, the political subdivision can reduce the cost of its debt financing. Another purpose for these underwritings may be to extend, defer, or realign the repayment of the original debt, since the proceeds of the refunding issue plus the investment return on the proceeds are sufficient to retire the existing issue, and repayment of the refunding issue would normally be due in serial amounts at later maturity dates than the original debt. This refunding concept also applies to corporate obligations, particularly industrial revenue obligations.

46. Omnibus Accounts. An omnibus account is an account carried on the books of one broker or dealer (the clearing broker), representing the activity of customers' accounts or firm trading and investment accounts that are carried on the books of another broker or dealer (initiating broker). The clearing broker may have omnibus accounts on its books for several different brokers or dealers, each one treated as a separate and distinct account. Normally, the initiating broker deals with only one firm for the purpose of clearing and carrying its customers' transactions.

47. Because of the large volume of transactions that may flow through an omnibus account, it is important that the clearing broker and the initiating broker reconcile such accounts frequently, preferably on a daily or weekly basis. The activity in the omnibus account is usually initiated when the initiating broker notifies the clearing broker of its firm trades or trades of its customers.

48. The clearing broker may perform a number of functions relating to the clearance and settlement of transactions (for example, receipt and delivery of securities, or transfer or segregation of securities) as instructed by the initiating broker. The initiating broker receives orders for its customers' securities transactions, prepares and sends confirmations and monthly statements to customers, and maintains customer accounts and margin records. Compensation of the clearing broker ordinarily is determined by a percentage of the commissions on the cleared transactions, a fixed charge based on the number of transactions cleared, a per item fee, an interest charge based on the average balance of the account, or any other method agreed to by the brokers.

49. Fully Disclosed Accounts. Fully disclosed accounts are the individual accounts of one broker's or dealer's customers (the introducing broker) carried on the books of another broker or dealer (the carrying broker). The carrying broker may maintain customers' accounts for several other brokers or dealers; an introducing broker generally would clear through only one broker.

50. Activity in a fully disclosed customer's account generally begins with an order for a trade communicated by the introducing broker to the order room of the carrying broker. The carrying broker is then responsible for the preparation and mailing of confirmations and monthly statements; clearance and settlement of securities and money transactions; and maintenance of detailed customers' ledgers, margin, and stock records. The customers are treated as if they were the carrying broker's own accounts except that correspondence to customers usually refers to the introducing broker by including a phrase such as

"through the courtesy of. . . ." The carrying broker is responsible for compliance with all regulatory requirements related to the carrying and maintaining of customers' accounts. The fees earned by the carrying broker generally represent a portion of the commission income generated in the account, or are determined by a fixed charge based on the number of transactions, a per item fee, or any other method agreed to by the brokers.

Accounting Records

51. Most brokers or dealers record securities transactions in the financial accounts on the settlement date rather than on the transaction (trade) date. Settlement date accounting is used to provide additional time for the orderly settlement of transactions, including confirmation of trades, cash transactions with the customer, comparison with the broker or dealer on the other side of the transaction, and delivery of the securities. Since generally accepted accounting principles normally require that financial effect be given to transactions at the time an event takes place--that is, an enterprise acquires a resource from or incurs an obligation to others--the use of settlement date accounting is not in accordance with such principles. Although the effect of this departure from generally accepted accounting principles normally may not be material, the impact and materiality of unsettled trades must be analyzed to determine the effects on inventory, on customer and other broker or dealer accounts, and on profitability. Based on this review, it may be appropriate for the broker or dealer to adjust certain general ledger accounts prior to issuance of financial statements and regulatory reports.

52. Record-keeping by brokers or dealers may be accomplished in a variety of ways, ranging from manually prepared records to sophisticated electronic data processing systems.

53. Many brokers or dealers have adopted computerized processing in various degrees of sophistication as a method of record-keeping. In some systems, the following items are placed on magnetic tapes, discs, or other storage media until they are ready to be used in the production of reports: stock records, details of customer transactions, margin records, and, in many cases, the general ledger. In computerized operations there are certain master files (principally security files and customer files) that are used in processing most of the work, together with programs for each operation. The security files normally include CUSIP (security) code numbers to identify the security for machine processing, a sufficient description of the security to properly identify it in printed reports, and its ticker symbol (if one exists). The customer file normally includes the customer account number; a number to identify the salesperson who handles the account; an office number (if appropriate); the name and address of the customer; and, if desired, delivery instructions and names of those to whom additional copies of confirmations or statements should be sent.

54. Some brokers and dealers using fully automated record-keeping systems have acquired their own electronic data processing equipment for in-house operations, thus necessitating the organization of an operations center and a systems department. Other firms use computer service bureaus.

55. Under a manual system the original source data (trade confirmations and information on cash receipts and disbursements and securities received and delivered) must be transcribed onto original entry journals or blotters. This is often done simultaneously with the posting of the activity to customer and broker statements or ledger cards. The stock record, normally a handwritten card maintained for each security, must then be posted individually. Because of the separate postings involved, the use of a manual system increases the possibility of posting errors.

56. Rule 17a-3 of the SEC specifies the books and records that must be maintained and kept current. Rule 17a-4 specifies the period of time that the books and records maintained under rule 17a-3, as well as certain additional records, must be preserved. Rule 17a-13 requires quarterly securities examinations, counts, verifications, and comparisons with the records, and the recording of differences as well as appropriate documentation of such procedures. Also, in their constitutions and rules, NASD and many securities exchanges require that members keep certain books and records. The prescribed records do not constitute an accounting system, but all accounting systems must include certain records that must be maintained on a current basis. Depending on the needs of the individual business, there are situations which may warrant the maintenance of certain additional records not specifically required under the rules of the various regulatory bodies.

57. When a broker or dealer operates as a sole proprietor, records must also be maintained of all assets and liabilities of the proprietor which are not related to the brokerage operation. Such records are necessary to permit determination of compliance with net capital requirements (which require that the excess of personal liabilities over assets not used in the business be treated as a deduction in the computation of net capital).

58. Financial Reporting Release no. 1, section 402.02, provides general guidelines for the maintenance of current books and records with respect to the requirements of rules 17a-3(a) and 17a-4.

59. Blotter Records. The basic records of original entry maintained by a broker or dealer are known as blotters. The term blotter is used in the securities industry as the term "journal" is used in other industries. Specifically, the blotters serve to record the details of cash receipts and disbursements, purchases and sales of securities (by market), receipts and deliveries of securities, and other appropriate debits and credits such as listings of floor brokerage receivables or payables, mutual fund commissions earned, and investment counseling fees. Blotters and related records of receipts and deliveries generally indicate the quantity, description, and certificate numbers of securities.

60. Stock Record. The stock record provides a composite listing of the long and short positions of each security for which the broker or dealer is responsible. The position sheet for each security identifies each owner, holder, or from whom a security is due. A long position in the stock record indicates ownership of the security or the right to possession. These may be customers; other brokers or dealers to or through whom a sale of securities, but not delivery, has been made; brokers and dealers or others from whom securities

have been borrowed; or the broker or dealer itself, if it has purchased securities for its own account.

61. Short positions in the stock record indicate either the location of the securities or the responsibility of other parties to deliver them to the broker or dealer. Every security owned or held by the broker or dealer must be accounted for by its location--such as in the active box, the safekeeping or segregation box, or a branch office box; whether it is with a transfer agent, or in transit between offices of the broker or dealer; or whether it is a stock loaned, held by a bank as collateral to a loan, or due from other parties. A short position is also used to reflect a broker's or dealer's short trading status in a security.

62. The long and short positions for each security must be in balance. In the event the total long and total short positions for a security are not equal, the amount required to balance is recorded in a difference account. Reasons for out-of-balance positions include a lag in the processing of one side of the transaction, miscoding of the transaction or the other side of the transaction, misfiling of a security movement ticket, or problems relating to the receipt or delivery of securities. The use of difference accounts is an aid to brokers and dealers in isolating problems for subsequent investigation. Electronic data processing (EDP) programs for the preparation of stock record reports are frequently designed to record any out-of-balance status in a difference account.

63. The speed and accuracy required in the maintenance of comprehensive listings, such as the stock record, has led to the widespread use of EDP equipment. Moreover, EDP equipment has provided a greater latitude and versatility in obtaining information and recasting it in various formats. For example, data as to securities held in segregation or safekeeping may be shown on the same stock record through the use of an additional column or memo entry, thus eliminating the need for a separate listing or summary. The entire stock record tabulation is generally prepared on a weekly basis, with a tabulation of changes produced on a daily basis.

64. Firms using manual systems normally maintain a separate record for each active security, filed alphabetically. Generally the top portion of the ledger record is used to record activity and balances for long positions, with the bottom section used to post short positions. Columns across the top of the page reflect stock record activity by date, with only the new balance of each long or short position affected by the transactions recorded on the card. The balance of all long versus all short positions should be checked periodically. This may be facilitated by bringing across to a current date (column) all open positions. With a manual stock record, any out-of-balance condition noted and not immediately corrected must be set up in a difference account.

65. Depository Records. Depositories provide for physical custody and transfer of certain securities and the settlement of security transactions between brokers or dealers without the physical movement of securities. Securities held by certain of the depositories may be pledged to banks as loan collateral without the physical transfer of the securities to the banks. Such depositories include:

- o Depository Trust Company (DTC)
- o Pacific Securities Depository Trust Company
- o Midwest Securities Trust Company

66. Each depository prepares daily reports for members indicating activity by security and the balance on deposit. Monthly or weekly, each member receives a statement of the balance of all securitv oositions.

67. It is the responsibility of brokers or dealers to disclose in their records whether the securities held at a depository are available for use as collateral for bank loans or should be reduced to possession or control as required by SEC rule 15c3-3. The status of such securities may be indicated on a computer-maintained stock record or in separate records kept to support the total stock record position shown for a depository.

68. Continuous Net Settlement Records. The following are examples of clearing organizations that have been established to facilitate the settlement of security transactions:

- o National Securities Clearing Corporation
- o Stock Clearing Corporation of Philadelphia
- o Pacific Clearing Corporation
- o Options Clearing Corporation
- o Midwest Clearing Corporation

69. Each clearing organization prepares daily reports for members showing the net security position (beginning balance plus sales and less purchases, plus receipts and less deliveries) by security and the net money balance that is due to or from the clearing organization.

70. Under such a system, each broker or dealer deals directly with the clearing organization, and individual transactions in the same security are netted. This results in one position in each security (either to deliver or to receive) between the broker or dealer and the clearing organization. Money is paid or received daily by the broker or dealer, so that the money balance in the account equals the net market value of the open security positions.

71. Failed-to-Receive and Failed-to-Deliver Records. A fail-to-receive results from a transaction to buy securities from another broker or dealer. The securities are not received from the selling broker by the settlement date and show short on the stock record with a corresponding liability on the general ledger. A fail-to-deliver results from a transaction to sell securities to another broker or dealer. If delivery of the securities is not made to the buying broker by the settlement date, the trade shows long on the stock record with a corresponding receivable on the general ledger.

72. Normally the cashier's department is responsible for unsettled securities transactions with other brokers or dealers. Under a manual system, the purchase and sales department may forward copies of trade confirmation tickets to the cashier's department. These tickets are filed in alphabetical order by settlement date. If the security is not received in or delivered out by the settlement date, the open tickets are transferred to the failed-to-receive or failed-to-deliver files. When the security is delivered out or received in, a copy of the confirmation ticket is sent to the accounting department as a basis for recording the security movement.

73. Some brokers and dealers develop "fail" items through a daily check of the various blotters. Under this system, for each fail the fail clerk prepares a memo slip indicating the date of the fail, the broker on the other side of the unit transaction, the number of shares, the description of the security, the unit price of the security, and the total dollar value of the transaction. The fail clerk usually keeps a file of fail slips in alphabetical order by security and by date of the fail. The securities and money balances listed on these slips or punch cards provide the supporting detail for the broker's or dealer's stock record fail security positions and for the general ledger fail money balance controls.

74. Brokers or dealers using some form of EDP normally send a copy of the fail slip to the data processing department for recording the fail in the automated records. The data processing department processes each fail, with details of the transaction, and routes the information back to the fail clerk. The fail clerk will then control and monitor all open fail items.

75. In other data processing systems, a punch card or other form containing similar information is prepared in advance of the settlement date for each transaction and is sent to the fail clerk. The transactions that clear on the settlement date are noted and cleared. The remaining transactions representing fails are forwarded to the data processing department for entry in the stock record (securities) and general ledger (money). The data processing department normally produces an updated file of fails and forwards to the fail clerk a current listing of open fails. When a fail is cleared (securities having been either received or delivered versus payment), the fail clerk notes the date of the clearance and then routes the information to the data processing department so that the fail position may be cleared from the broker's or dealer's records. Some systems also use details of open fails to compare the cashier's department detail records to related stock record positions and general ledger money balances.

76. Some brokers or dealers record all fail transactions in a separate account for each other broker or dealer with whom they execute transactions. These records are maintained as ledger accounts in the same form as the accounts maintained for customers. These individual accounts, reflecting only the net fails, must be broadened or grossed up both for financial reporting purposes and for comparison with the lists of open fails-to-receive and fails-to-deliver.

77. Brokers and dealers clearing transactions through correspondent brokers located in exchange centers normally maintain fail-to-receive and fail-to-deliver records only for transactions initiated by their trading departments

with over-the-counter brokers or dealers. These records may be maintained in ledger accounts similar to those used for customers.

78. Securities Borrowed and Securities Loaned Records. Normally, details of securities borrowed from or loaned to others are recorded in a stocks borrowed and loaned ledger or on individual stocks borrowed and loaned information sheets. They also may be recorded in an account similar to that of a customer. The cashier's department records contain all applicable details of the stocks borrowed and loaned transactions such as date, description of the security, quantity, total amount of the deposit made (stocks borrowed) or received (stocks loaned), and from whom borrowed or to whom loaned. As with fail-to-receive and fail-to-deliver items, these records will provide the supporting details for the stock record borrowed and loaned security positions, as well as for the general ledger money control of amounts due to and from others with respect to these transactions. In some cases, U.S. Treasury securities may be used as collateral in place of a deposit of funds in connection with stocks borrowed or loaned.

79. In automated systems, information may be prepared for each stock borrowed and loaned position and retained in the cashier's department to be used as the basis for an "out-of-loaned" or "out-of-borrowed" entry and also in the comparison of cashier's department records with the stock record and general ledger for control purposes.

80. Collateral Loan Records. A separate record should be maintained in the cashier's department for each bank loan. This record should indicate the name of the bank, the dollar amount of the loan, and the interest rate. This record should also include the quantity, description and market value of securities held by the bank as collateral for the loan. In certain data processing systems a separate file for securities used as collateral may be maintained in the cashier's department. The loan records or the file represent the supporting details of the general ledger dollar amounts and the stock record collateral loan security positions.

81. When collateral loan securities are recalled from the bank or when additional securities are forwarded to the bank, either in substitution for securities recalled or as additional collateral, entries are prepared by the cashier's department and forwarded to the bookkeeping or data processing department for entry in the stock record.

82. In some systems, particularly EDP systems, separate accounts are maintained in the general ledger for each loan with separate positions being maintained in the stock record for the securities collateralizing each loan. In other systems, usually manual systems, the stock record may contain only one collateral loan position for each security instead of a separate position for each loan.

83. Transfer Records. The cashier's or margin department of a broker or dealer normally prepares written security transfer instructions on a multipart form. These instructions include the name in which the new certificates are to be registered (and the account number and mailing address if they are to be registered in a customer's name), the number of shares or principal amount and

description of the securities, instructions indicating whether the new certificates are to be sent to the customer or held by the broker or dealer for the customer's account and certificate numbers of the securities being transferred. The instructions are sometimes separated between those covering securities to be transferred to the broker's or dealer's name or that of its nominee and those covering securities to be transferred to the customer's name. A copy of the instruction ticket is sent to the stock record department or to the data processing department to record the security as "in transfer" on the stock record. One copy of the instruction form is maintained in an open transfer ticket file that constitutes the supporting detail for the stock record transfer position. At least one additional copy of the instruction form is sent to the transfer agent with the securities to be transferred. In exchange centers such as New York, the broker or dealer normally prepares "broker-originated window tickets" for securities going to transfer. These tickets are numbered and are normally in triplicate. Two copies accompany the security going to transfer; the other is retained by the broker or dealer. The transfer agent returns one with the security and retains the other for reference purposes. The use of these tickets facilitates the proper identification of transfer items received from the transfer agent and allows the broker or dealer to question the transfer agent regarding specific items.

84. In manual accounting systems the securities received from transfer are matched against the open transfer instructions, with a copy of the completed instructions used as the basis for removing the open transfer position from the stock record.

85. In automated systems, multipart transfer instruction forms and punched cards may be produced simultaneously for each security going to transfer. If such cards are prepared, they are maintained in the transfer department as an open card file by security and by date of order. When securities are received from transfer agents, they are matched against the punch cards on file, and the cards are used as out-of-transfer entries. They are sent to the data processing department as a basis for removing open transfer positions from stock records. Those cards remaining in the transfer department provide the supporting detail for the transfer positions in the stock record.

86. Active Securities Records. Active securities are those used by the broker or dealer in carrying out its daily business. These include customers' securities not paid for, securities purchased by customers on margin with collateralized funds advanced by the broker against the purchase price, securities owned by the broker or dealer, and other proprietary securities.

87. Personnel in the cashier's department prepare records showing the daily movements in and out of the active box. Forms used for recording daily activity are normally referred to as "in-box" sheets and "out-box" sheets. At the end of each day, copies of these sheets are sent to the stock record department or to the EDP department as a basis for entries that reflect the security movement.

88. Some brokers or dealers use copies of the receipt and delivery tickets, in lieu of the in-box and out-box sheets, to notify the stock record department of the security movement.

89. Safekeeping and Segregation Securities Records. Safekeeping securities are customers' securities that are fully paid for and that are held in custody by the broker or dealer for the accounts of customers. Safekeeping securities normally are registered in the name of the customer.

90. Segregation securities are securities registered in the name of the broker or dealer. They are set aside for customers who have fully paid for such securities, or they represent securities of margin customers in excess of margin requirements. Although segregated securities may be identified specifically by customer, in most cases they are segregated in bulk on a fungible basis.

91. Securities usually are transferred to and from safekeeping and segregation on the basis of instructions prepared by the cashier's or margin department. The instructions reflect the customer's name, the quantity and description of the security, the date of preparation of the instructions, and the customer's account number. If a multipart form is used as the instruction ticket, one copy is retained by the margin department and another copy is sent to the cashier's department. A copy may be forwarded to the stock record department or to the data processing department to record the security movement when changes take place in safekeeping or segregation securities.

92. In a non-bulk (specifically identified) system, the instruction ticket for moving securities into segregation or safekeeping is normally maintained in an open or pending file in the cashier's department where it awaits receipt of the security in proper form for placement into the vault. When the securities are received and placed in the vault, the instruction ticket is removed from the open file and the certificate numbers and the date the securities were placed in the vault are recorded on the instruction ticket. Securities pending safekeeping or segregation (securities designated to be placed in safekeeping or segregation) are securities that currently may be failed-to-receive items, transfer items, or items located elsewhere such as in the active box, out on loan to another broker, or collateral for bank loans.

93. In some automated systems, the EDP department prepares listings based on "into-segregation" or "into-safekeeping" instructions issued by the margin department. The information is sent to the cashier's cage for use as the instruction to "lock up" the security, and may be sent to the margin department for subsequent use as release instructions. A copy of the original instruction is filed by the originating department, and an additional copy may be sent to the cashier's department to be attached to the securities as the customer identification for safekeeping and non-bulk (specifically identified) segregation.

94. In a manually operated system of bulk segregation or safekeeping, the ownership of the securities usually is reflected by copies of the instructions filed in security order sequence by customer. A separate record is sometimes maintained for each security, showing the total number of shares or principal amount of bonds in safekeeping or segregation that should be in agreement with the total quantities shown on the copies of the instructions and the segregation and safekeeping positions in the stock record. In automated systems, the ownership of bulk segregation and safekeeping is usually indicated by means of additional columns in the stock record.

95. Brokers and dealers sometimes use another method of bulk segregation with EDP systems. Instructions for the segregation or release from segregation of securities are issued by the margin department. These instructions are processed into the broker's or dealer's stock record, and a comparison of customer segregation requirements is made with the quantity of specific securities presently in possession or control. This comparison generates a report to the cashier's department indicating, by issue, the number of shares pending that must be placed in segregation by the cashier and the number of shares in excess of requirements that may be removed from segregation by the cashier. The cashier's department carries out the instructions generated by this comparison which is normally produced on a daily basis by the data processing department. Since this bulk system does not relate certificates to specific customers, it is not feasible to determine, in the case of a pending segregation condition, the particular customer for whom segregation has not been accomplished.

96. Security Difference Records. Securities differences may be caused by inaccurate record-keeping on the part of a broker or dealer, by an out-of-balance condition in the stock record or by errors in receipt and delivery of securities. Such differences are normally disclosed through periodic counts of securities on hand and by examination or confirmation of items such as transfers and fails.

97. When a security difference is disclosed, it should be recorded in a security difference account, pending research as to the reason for the difference. When the difference is resolved, entries are made clearing the difference position from the stock record. If the difference is not resolved after appropriate research, rule 15c3-3 requires the broker or dealer to "buy in" the shortages. Subject to legal interpretation as to ownership, the overages may be sold.

98. Rule 17a-13 of the '34 act requires that at least once in each calendar quarter, but not more than four months or less than two months apart, all positions in each security must be accounted for simultaneously, although not all securities must be accounted for at the same time. The broker or dealer must

- Physically examine and count all securities held.

- Account for all securities subject to its control and direction, but not in its possession, by examination and comparison of the supporting detail records with the appropriate ledger accounts.

- Verify (by communicating with the brokers or dealers, transfer agents, and so forth) all securities that have been subject to its control and direction for longer than thirty days.

- Compare the results of the count and verification with its records. And,

- Record within seven business days after each required quarterly security examination all unresolved differences in a security difference account setting forth the security involved and the date of comparison.

99. Cash Receipts and Disbursements Records. Checks or cash are received from customers, brokers, clearing organizations, and banks "over-the-window" by messengers, via the mail, and through wire transfers or drafts. Depending on the system, cash receipts may be

- o Recorded by hand in a daily cash blotter.
- o Recorded in a cash receipts journal by a bookkeeping machine.
- o Recorded on a machine that types a receipt form and a paper punch tape that is used to prepare a daily cash receipts blotter.
- o Recorded by the data processing department or computer service bureau from a marked copy of the confirmation.

100. Disbursements normally are made by check, draft, or wire transfers. Checks to customers are prepared on the basis of check requests received from the margin or cashier's department. The cash disbursements journal, copy of the confirmation marked accordingly or blotter on which the transactions have been entered is sent to the data processing, bookkeeping or controller's department for entry.

101. Receipts and disbursements for the day are totaled on the journals or blotters, and the closing balance for each bank account is determined. A summary of the postings is prepared showing the distribution to the control accounts in the general ledger. The summary is agreed with the totals of the various source documents and with related items in the summaries prepared by the receive and deliver departments. In addition to the settlement and cash journal summaries, brokers or dealers may prepare an overall summary of cash transactions processed by the cashier's department. Normally this cash summary sheet contains numerous descriptive categories and columns to which the cash movements (totals) and settlement values of all security movements are posted. Entries are compiled by summarizing appropriate working documents, including blotters, journals, drafts and various other receipt and disbursement forms.

102. Margin Department Records. The margin department normally has the overall responsibility for the proper maintenance of customer accounts and control of the extension of credit. Although the form of their records will vary, depending on whether the accounts are maintained manually or on computerized accounting systems, the information contained in margin department records is generally the same. Margin department records, which are maintained on a trade date basis, are posted from copies of transaction tickets received from the purchase and sale, cashier's, dividend, and accounting departments.

103. Records in the margin department will normally indicate for each margin customer the market value of the securities, the money balance of the account, the excess of deficit margin, the transfer, the safekeeping and segregation instructions, the pending trades and the special miscellaneous account (SMA) balance calculated in conformity with regulation T.

104. The margin department's principal function is to check the credit status of customers. It is responsible for initiating margin calls, maintenance

margin calls, extensions of time for cash account customers to pay for securities purchased, and instructions for moving securities to or from safekeeping or segregation. Copies of documents relating to these transactions are maintained in the margin department.

105. Other records and information that may be maintained by the margin department are standing customer instructions regarding the delivery of securities, the disposition of cash from the sale of securities or the receipt of dividends and interest and guarantees of customers' accounts.

106. Dividend Department Records. The dividend department is responsible for records relating to all types of distributions made on securities, including cash dividends, stock dividends, rights, and splits. It may also forward proxy material to customers.

107. On the dividend record date, listings are supplied to the dividend department showing the registered holder and location of each security. The record will indicate how the securities are registered--that is, in the name of the broker or dealer; its customers; or in the name of another broker, dealer, or individual from whom the dividend must be claimed. In order to reduce the number of dividend claims, it is normal procedure for the dividend department to notify the cashier's department on a daily basis about securities approaching dividend record dates. The cashier's department will then check for securities on hand that are registered in a name other than its own and will attempt to deliver such securities to the transfer agent so that the registration may be transferred to its own name as of the record date. Brokers or dealers with computerized systems may use magnetic tapes provided by dividend reporting services to disseminate record date information.

108. For each dividend distribution, the dividend department prepares a memo proof to ascertain the total receipts and disbursements that will be processed.

109. The dividend department instructs the accounting department or the data processing department as to which customers should be credited or charged for the dividend. The contra entry is made to a dividend receivable or payable account. Differences between the amount received and the amount receivable represent items that must be investigated by the dividend department.

110. The dividend department also maintains a record of securities that the broker or dealer is failing to receive or to deliver on the dividend record date. Securities received or delivered against fails that were open on the record date and are in the name of the delivering broker should be accompanied by due bills. It is usually the responsibility of the dividend department to effect collection or authorize payments for transactions of this nature. Brokers and dealers should maintain dividend records for each security by individual declaration date and should not combine all dividends received for each security over a period of time. For example, Company X declares a dividend to holders of record on January 2 and later declares another dividend to holders of record on April 1. The broker or dealer may have a receivable of $5,000 for the January 2 dividend, but may have received $5,500. This would indicate that the broker or dealer was either failing to deliver and owes other brokers $500,

or that another broker should make claim for the $500 for securities it is holding but which are still registered in the broker's or dealer's name. For the April 1 dividend the broker or dealer may have a receivable of $6,000, but may have received only $5,200. The dividend department would have to determine which other brokers owed the $800, either for securities that the broker or dealer had failed to receive or for securities not yet transferred into the broker's or dealer's own name from the name of the other brokers. The dividend record should show a payable of $500 for the January 2 dividend and a receivable of $800 for the April 1 dividend.

111. Dividends received that have not been paid or credited because proper account identification cannot be made are considered to be unclaimed dividends and normally are paid only upon receipt of valid claims. Balances remaining in dividends payable may be subject to abandoned property laws.

112. Customers' Securities Account Records. Separate accounts must be maintained for each customer, and a statement of the account must be sent to the customer at least quarterly as required by regulatory bodies. Transactions in the accounts cover both money and positions, with the security transaction and related money generally recorded on the settlement date. The accounts should include an itemization of all purchases; sales; receipts and deliveries of securities; and all other debits and credits, including dividends and interest received or charged and investment counseling fees. The accounts are generally maintained so that money balances and security positions are clearly indicated.

113. A customer may have many different accounts that are subject to cash or margin regulations. Cash, margin, income, short sale, and other accounts are commonly encountered.

114. Cash account--The cash account provides a record of cash transactions expected to be cleared within the time limit prescribed by regulation T of the Board of Governors of the Federal Reserve System. Cash account purchases are limited by regulation T to purchases for which sufficient funds are held in the account, or in reliance on an agreement that the customer will promptly make full cash payment for the security, and that the customer does not contemplate selling the security prior to making such payment. Cash account sales are similarly limited to sales for which the security is held in account or in reliance on an agreement that the customer owns the security and will make prompt delivery.

115. Normally, full cash payment must be made within seven business days after the date the security is purchased. Assuming a five-day settlement period, full cash payment must be made no later than two business days after the settlement date. However, if a customer purchases a security with the understanding that the security will be promptly delivered and that the full cash payment will be made promptly against such delivery (a cash-on-delivery (COD) or delivery-versus-payment (DVP) account), the time period for making payment is not to exceed 35 calendar days. Failure to make timely payment would ordinarily require the prompt cancellation or liquidation of the transaction. In exceptional cases, the seven business day and 35 calendar day periods may be extended for one or more limited periods by applying to a committee of a national securities exchange or to the NASD.

116. Historically, certain regulatory bodies have restricted the acceptance of sales orders, other than short sales, unless there was a reasonable prospect of making "prompt" delivery of securities against the sale. "Prompt" delivery was not defined in regulation T or elsewhere. Rule 15c3-3 now requires that if a security sold, other than a short sale, is not received from the customer within ten business days after settlement date, the broker must immediately close the transaction by purchase of the related security for the account of the selling customer. Certain state and municipal bonds are exempt from this buy-in requirement.

117. Margin account--The margin account provides a record of purchase transactions for which the broker or dealer is expected to extend credit. The amount of credit extended is subject to the limits prescribed by regulation T. This regulation establishes the maximum loan value of the securities in the account and requires the broker or dealer to obtain, as promptly as possible but before the expiration of five full business days following the date of the transaction, a deposit of cash or securities necessary to eliminate any margin deficiency. Assuming a five business day settlement period, the deposit would be required no later than the settlement date. In exceptional cases, the five-day period may be extended for one or more limited periods by applying to a committee of a national securities exchange or to the NASD. Maximum loan values for securities are prescribed periodically by a supplement to regulation T. In addition, certain securities exchanges have rules establishing minimum maintenance margin requirements. A broker or dealer may establish initial or maintenance margin requirements that are greater than those required by the rules of the regulatory bodies.

118. Income account--The income account provides a record of interest and dividends received on securities maintained in other accounts.

119. Short sale account--Transactions in securities sold short are recorded in a short sale account. Such transactions are also governed by the margin requirements of regulation T. On a short sale transaction, the broker or dealer is expected to lend or arrange for the lending of the security to the customer for the purpose of effecting delivery.

120. Other accounts--Other special accounts are provided for (a) the purchase of securities through the exercise of rights or warrants; (b) bond transactions in exempted, municipal, and registered non-equity securities purchased on margin; (c) transactions in convertible debt securities purchased on margin that are convertible into margin stock or that carry a right to subscribe to or purchase such stock; and (d) option transactions. Regulation T prescribes different loan values and the length of time that credit can be extended in these accounts.

121. Trading and Investment Account Records. Trading securities are considered as inventory or stock-in-trade. Investment securities are purchased with the expectation of capital gain. To qualify for capital gain treatment under the present Internal Revenue Code, the broker's or dealer's records must clearly indicate, before the expiration of the thirtieth day after purchase, that the security is held for investment and not for trading purposes.

122. Brokers or dealers may purchase, for investment, securities that are not readily marketable or that are restricted as to sale by the purchase terms. These securities should be recorded separately in the accounts of a broker or dealer and clearly designated.

123. The trading department maintains separate records on a trade date basis. It is important that the broker or dealer reconcile these records periodically with the accounting department records, which are normally maintained on a settlement date basis.

124. Underwriting Department Records. A broker or dealer that participates in underwriting activities normally will function as either the managing underwriter or a participating underwriter. A managing underwriter, in addition to being a participating underwriter, normally negotiates the transaction with the issuer of the security and maintains the records of the underwriting group.

125. The managing underwriter maintains daily position listings of the entire issue and ascertains the status of securities subscribed to and whether they have been delivered to the participating underwriters. Expenses associated with each underwriting are accumulated in the general ledger in separate accounts. When the underwriting is completed, the profit or loss on the underwriting is determined and distributed to the participating underwriters.

126. The participating underwriters will maintain records of each underwriting participation only to the extent in which they are involved.

127. Commodity Department Records. The books and records maintained by brokers or dealers dealing in commodities include customer and firm positions and open commodity futures contracts. At the time a customer enters into a commodity futures contract, which is an agreement to buy or sell at some future date, he is sent a purchases-and-sales form, but no entries are recorded in the broker's or dealer's general ledger accounts other than the amount of any margin deposit made by the customer. Nevertheless, a record in the form of a contract book is maintained by commodity and by maturity date. When an offsetting purchase or sale contract is made, the open trade in the contract book is so noted. In manual systems, there is usually a separate page in the record for each commodity delivery month and space to note the completion of the transaction. In computerized systems, listings can be made periodically in chronological order, and posting space and order requirements are rather flexible.

128. The commodity blotter is a record of the actual purchase or sale at the completion of what is called a "round turn"--that is, a purchase or sale offsetting an existing open contract. In addition to entering a description of the transaction, the amount of the resulting gain or loss to the customer is recorded.

129. The contract position record is maintained on a daily basis showing the positions in each commodity carried for customers or for the broker's or dealer's own account. It shows a balancing of futures contracts by customers offset by the net position with the carrying broker or with the clearing association. Finally, there is a customers' commodity ledger that is used to

record commodity transactions for each customer and carrying broker. Completed transactions, money, and contracts are posted daily from the regular blotter record of cash receipts and disbursements and the commodity blotter for gains, losses, and commissions. (For a discussion of commodity transactions, refer to Chapter 7 of this guide, "Commodities Transactions.")

130. <u>SEC Rules 15c3-1 and 15c3-3</u>. The broker or dealer is required to be in compliance with the net capital rule (rule 15c3-1) at all times. At least monthly a broker or dealer is required to prepare and maintain a record of the proof of money balances of all ledger accounts in the form of trial balances and a record of the computation of aggregate indebtedness if applicable (unless the alternative capital computation is being followed) and net capital under rule 15c3-1, as of the same date. In addition, rule 15c3-3 requires that records be maintained of the periodic (weekly or monthly) calculations of the deposits required in the special reserve bank account for customers and that compliance with the requirements for maintaining physical possession or control of fully paid and excess margin securities of customers be documented.

CHAPTER 2

FINANCIAL STATEMENTS AND REPORTS

Financial and Operational Combined Uniform Single Report

131. On December 17, 1975, the SEC announced in Release no. 11935 under the '34 act, the adoption of the FOCUS report as the reporting system for brokers or dealers. This announcement had a significant effect on the annual audit of a broker or dealer. It eliminated the Answers to Financial Questionnaire as an audit report and replaced it with financial statements that present financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles.

132. The annual audited financial statements must be filed by every member of a national securities exchange who transacts a business in securities directly with or for persons other than members of a national securities exchange, by every broker or dealer (other than a member) who transacts a business in securities through a medium of any member of a national securities exchange and by every broker or dealer registered in accordance with section 15 of the '34 act.

133. Under the revised rules, a broker or dealer is required to file financial statements in the form prescribed by the SEC at the end of each calendar quarter on part II or part IIA of the FOCUS report. (In certain cases, such as when a broker or dealer exceeds certain parameters of financial and operational conditions, part II or part IIA must be filed monthly or weekly.) In addition, audited financial statements are required to be filed on a fiscal or calendar year basis as of a date selected by the broker or dealer. The annual audit for subsequent years must be as of the same date unless the SEC issues prior approval for a change of the broker's or dealer's fiscal year.[1] If the broker or dealer selects a date for the annual audited financial statements that is other than the close of a calendar quarter, an additional unaudited Form X-17A-5, part II or IIA, of the FOCUS report must be filed by the broker or dealer as of the date of the annual audit.

134. Rule 17a-5 states that the annual audited financial statements must include

- o Statement of financial condition
- o Statement of income (loss)

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[1]Rule 17a-5 defines "fiscal year" as the broker's or dealer's fiscal year for reporting purposes; the fiscal year is not necessarily the same as the tax year. For purposes of defining a time period such as fiscal or calendar quarter, the last Friday or last business day of such period is acceptable.

- o Statement of changes in financial position

- o Statement of changes in stockholders' equity or partners' or sole proprietor's capital

- o Statement of changes in liabilities subordinated to claims of general creditors

135. The contents of each of these statements are discussed in this chapter, and illustrations are presented in the Financial Statement Exhibits section. Brokers or dealers that have issued securities to the public are subject to the disclosure rules that apply to publicly-held companies. Such rules require the dissemination of comprehensive financial information to stockholders, including statements of income and changes in financial position.

136. The annual audited financial statements must also contain the following supplementary schedules required by SEC rule 17a-5:

- o Computation of net capital pursuant to rule 15c3-1

- o Computation for determination of reserve requirements pursuant to rule 15c3-3

- o Information relating to the possession or control requirements pursuant to rule 15c3-3

- o Schedule of segregation requirements and funds in segregation pursuant to the Commodity Exchange Act

- o A reconciliation between the audited computation of net capital under rule 15c3-1, the audited computation for determination of the reserve requirements under exhibit A of rule 15c3-3 and the audited computation of funds in segregation pursuant to the Commodity Exchange Act, and the corresponding computations included in the unaudited FOCUS filing or a statement that one is not necessary pursuant to rule 17a-5(d)(4)

137. Two copies of the annual audited financial statements must be filed with the SEC's principal office in Washington, D.C., and one copy with the appropriate regional office of the SEC and with the designated examining authority for the broker or dealer, no later than sixty days after the date of the financial statements. If required, an extension of time for filing can be requested. It is also necessary to provide copies to all self-regulatory organizations of which the broker or dealer is a member and the states in which the broker or dealer is registered.

138. The SEC will treat the annual audited financial statements filed with it as public documents. However, some degree of confidentiality may be achieved by filing two separate sets of financial statements. The set which will be treated as a public document need contain only the auditor's report, the statement of financial condition, the related notes, and the report on internal accounting control. The second, complete set of financial statements should be marked "CONFIDENTIAL" (see paragraphs 134 and 136 above).

139. A report on the status of the membership of the broker or dealer in SIPC for periods through June 30, 1978, was also required to be filed concurrently with the filing of the annual audited financial statements.[2] Subsequent to June 30, 1978, the SIPC assessment was reduced to a minimum level and the requirement for a separate auditor's report on the assessment was suspended. This supplemental report was bound separately from the audited financial statements and was filed with the regional and Washington offices of the SEC, SIPC, and the designated examining authority. The SIPC report contained a schedule of assessment payments (showing any overpayments applied or carried forward), including details as to payment dates, amounts and the name of the SIPC collection agent or, if exclusion from membership was claimed, details as to the filing of the form requesting exclusion from membership.

Financial Statements to be Furnished to Customers

140. Within 105 days of its reporting year-end a broker or dealer is required to furnish the following information to each customer as defined in rule 17a-5:

- An audited statement of financial condition and related notes which should be prepared in conformity with generally accepted accounting principles, including a note on the company's consolidation policy and a note indicating the amount of the broker's or dealer's actual net capital and the amount of required net capital

- If material inadequacies were reported as a result of the most recent annual audit, the broker or dealer must indicate that a copy of the report on internal control is available for inspection at the SEC's principal and regional offices.[3]

141. A copy of the statement of financial condition sent to customers must be filed with the SEC's principal and regional office and with the designated examining authority.

142. The broker or dealer also is required by the SEC to furnish customers with an unaudited statement of financial condition dated six months subsequent to the date of the audited financial statements. The unaudited statement must conform to the audited statement with respect to presentation and disclosure requirements.

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[2]Rule 17a-5(e)(4)(iii) required that the accountant's review on which his report is based shall include, at a minimum, certain procedures included in sections (a) through (g) of the rule pertaining to the status of the broker's or dealer's membership in SIPC.

[3]Material inadequacies and related considerations are explained in the section of Chapter 3 that deals with "Reporting on Internal Accounting Control by Independent Auditors."

Consolidated Financial Statements

143. Normally, annual audited financial statements are presented on a consolidated basis.

144. The instructions for financial statements on Form X-17A-5, part II or part IIA, require that certain subsidiaries be consolidated if the broker or dealer has guaranteed, endorsed or assumed the obligations or liabilities of those subsidiaries, and permits the consolidation of other subsidiaries. If, however, the effect of consolidating any subsidiary is to improve net capital or the net capital ratio computed pursuant to rule 15c3-1, the broker or dealer must obtain an opinion from legal counsel as of the date of the financial statements that the net assets of the subsidiary can be liquidated and distributed to the broker or dealer within 30 calendar days. Consolidation of a subsidiary that improves net capital or the net capital ratio is not permitted unless such a legal opinion is obtained. If the statement of financial condition filed on Form X-17A-5, part II or part IIA, is not on a consolidated basis, there may be differences between it and the statement reported on by the independent auditor. The SEC requires that such differences be disclosed in a note to the audited financial statements.

Statement of Financial Condition

145. The audited statement of financial condition must be in a format and on a basis consistent with the totals reported on the statement of financial condition contained in Form X-17A-5, part II or part IIA, as filed by the broker or dealer.

146. The presentation of the statement of financial condition must conform with generally accepted accounting principles.

- Subordinated debt and stockholders' equity (or partners' capital) should be classified separately. It is not permissible to present a combination of subordinated liabilities and stockholders' equity (or partners' capital) regardless of the disclosure of the components or the use of descriptive caption titles (see Financial Statement Exhibit B).

- The statement of financial condition, when presented with the other basic financial statements, should disclose the components of stockholders' equity (for example, preferred stock, common stock, and retained earnings).

- The statement of financial condition presented alone (for example, statement of financial condition bound separately for SEC (see paragraph 138) and statement of financial condition furnished to customers (see paragraph 140)) need not disclose the components of stockholders' equity.

- Current and noncurrent classifications need not be presented for the statement of financial condition. Such a distinction normally has little meaning for brokers and dealers and may, in fact, be misleading. For example, margin debit balances payable on demand are normally maintained (if properly margined) on a long-term basis.

Statement of Income (Loss)

147. The statement of income (loss) should be in a format that is consistent with such a statement as contained in Form X-17A-5, part II or part IIA, and should disclose separately the sources of the broker's or dealer's revenues--such as brokerage commissions, trading profits or losses, investment profits or losses, underwriting profits or losses, fee income, dividends, and interest. Expenses should be reported by major types such as employee compensation and benefits, communications, occupancy and equipment, interest, floor brokerage and clearance fees, and so forth.

Statement of Changes in Financial Position

148. The statement of changes in financial position is required when financial statements present financial position and results of operations in conformity with generally accepted accounting principles.

Statement of Changes in Ownership Equity

149. The statement of changes in ownership equity should be in a format that is consistent with such statement as contained in Form X-17A-5, part II or part IIA. This statement is required whether or not the reporting broker or dealer is a corporation, partnership, or sole proprietor. It should disclose the principal changes in the equity accounts of the broker or dealer during the periods. This statement can be omitted if the required information is presented in a note to the financial statements.

Statement of Changes in Liabilities Subordinated to Claims of General Creditors

150. This information is required by the SEC and may be included in the notes to the financial statements.

Notes to the Financial Statements

151. In addition to other disclosures ordinarily required by generally accepted accounting principles, summary financial information concerning subsidiaries consolidated under the "flow-through" capital benefits of appendix C of rule 15c3-1, and the effect on net capital and the required net capital of the broker or dealer must be given in the Notes to the Statement of Financial

Condition furnished to customers. Further, if accounts of other subsidiaries are consolidated in conformity with generally accepted accounting principles but are not permitted to be consolidated under FOCUS filing requirements, disclosure of summary financial data for those subsidiaries, including assets, liabilities, and net worth, is required by the SEC.

Supplemental Schedules

152. Computation of Net Capital Pursuant to Rule 15c3-1. This schedule shows the amounts necessary to determine the net capital and the required net capital of the broker or dealer. A reconciliation is required if material differences exist betweeen the schedule reported on by the independent auditor and the broker's or dealer's unaudited filing of part II or part IIA of the FOCUS report. If no material differences exist, a statement indicating that must be made.

153. Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3. This schedule provides a comparison of customer-related credit balances, the short market valuation of certain customer-related accounts, and certain customer-related debit balances. If total credits, as defined by rule 15c3-3, exceed total debits as defined, a deposit in a special reserve bank account for the exclusive benefit of customers must be made. The SEC requires reconciliation of material differences between the computation included with the financial statements reported on by the independent auditor and the computation previously filed by the broker or dealer in the FOCUS report.

154. Information Relating to Possession or Control Requirements Under Rule 15c3-3. This schedule discloses the market value of securities required to be in possession or control that had not been reduced to possession or control in the proper time frame because properly issued segregation instructions were not acted upon, or segregation instructions were not issued. Both the market value and number of related security positions must be reported.

155. Schedule of Segregation Requirements and Funds in Segregation Pursuant to the Commodity Exchange Act. This schedule shows the computation of the amount of funds contained in customers' regulated commodity futures accounts which must be segregated pursuant to the Commodity Exchange Act and the total funds segregated by the broker or dealer to meet these requirements.

Account Descriptions

156. Many items set forth in the Financial Statement Exhibits section are self-explanatory. The captions in the following paragraphs require special comment.

157. Cash. Cash in banks subject to withdrawal restrictions, restricted deposits held as compensating balances, or cash segregated in compliance with federal or other regulations (such as cash required to be segregated under the Commodity Futures Trading Commission Act of 1974 or cash in a special reserve bank account for the exclusive benefit of customers) should be classified

separately in the statement of financial condition or appropriately disclosed in a note.

158. Memberships in Exchanges. Exchange memberships owned by a broker or dealer are generally acquired for operating purposes and should be valued at cost or at a lesser amount where there is a permanent impairment in value. Exchange memberships contributed for the use of the broker or dealer and subordinated to claims of general creditors should be carried at market value with an offsetting amount shown under liabilities subordinated to claims of general creditors.

159. Receivable From Brokers, Dealers, and Clearing Organizations. This classification includes amounts receivable for securities failed to deliver, amounts deposited for securities borrowed, amounts receivable from clearing organizations relating to open transactions, and receivables for commodities futures accounts liquidating to a deficit on the broker's or dealer's records. If the broker or dealer clears through correspondents, there may be debit balances in the omnibus accounts of one or more of the correspondents. If the amounts are not material, they may be included in this classification. If material, such balances should be shown separately as "Due From Correspondent Brokers."

160. Payable to Brokers, Dealers, and Clearing Organizations. This classification includes amounts payable for securities failed to receive, deposits received for securities loaned and amounts payable to clearing organizations. Also included under this classification are payables for commodities futures accounts liquidating to an equity in the broker's or dealer's accounts. If the broker or dealer clears through correspondents, the credit balances in omnibus accounts of correspondents may be included under this classification, provided the amounts are not material. If material, such balances should be shown separately as "Due to Clearing Brokers."

161. Receivable From and Payable to Customers. Customers, as defined in rule 15c3-1 subparagraph (c)(6), include all accounts resulting from normal securities and commodities transactions other than with other brokers or dealers or persons whose securities or funds either are part of the net capital of the broker or dealer or are subordinated to claims of general creditors. A broker or dealer account can be classified as a customer if the account is carried as an omnibus account in compliance with regulation T. The accounts of officers, directors, stockholders, and employees may be included in the customer captions if they are not material. Noncustomer accounts (as defined in rule 15c3-1 subparagraph (c)(7)), if material, should be shown separately.

162. Customer commodity accounts include gains and losses on commodity futures contracts liquidating to a deficit (receivable) or equity (payable) in addition to ledger balances.

163. Customers' partly secured and unsecured accounts are included in this caption, and an appropriate asset valuation allowance should be established for these and other accounts if losses are probable.

164. Securities Purchased Under Agreements to Resell. These balances arise from "reverse repurchase agreement" security transactions that are essentially secured receivables. The receivables are carried at purchase price under an agreement to resell the securities to the seller.

Trading and Investment Accounts

165. Trading Account. Trading accounts include marketable securities, options, and spot or future commodities items, which are purchased by a broker or dealer in the ordinary course of business for the purpose of maintaining them in inventory for sale to customers. (A dealer in securities is a merchant who makes a two-sided market quoting at the same time both a price at which he will buy and a price at which he will sell. For example, dealers include specialists on the floor of securities exchanges, regular options traders on the floor of exchanges, or brokers who enter bid or ask prices in the "pink sheets" or in the National Association of Securities Dealers Automated Quotation system.) For tax purposes, the profit or loss from these transactions normally will result in ordinary income or loss.

166. Because of the number of transactions that take place in the dealer's account, mistakes occasionally occur. These mistakes would be placed in the broker's or dealer's error account and normally would be included as part of the dealer's transactions.

167. Investment Account. Investment accounts include marketable securities, options, spot, or future commodities items such as venture capital investments, oil and gas leases, and real estate investments. These investments are normally held for a long period of time and do not have a rapid turnover. For tax purposes, these types of transactions will generally result in long-term capital gain or loss. Investment accounts should be classified into two categories: marketable investments and investments with no "ready market."[4] Investments with no ready market include

- Securities for which there is no market on a securities exchange or no independent publicly quoted market;

- Securities which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption, such as regulation A, under section 3(b) of such act have been complied with); and

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[4]Generally, the term "ready market" shall include a recognized, established securities market in which there exists independent bona fide offers to buy and sell, so that price reasonably related to the last sale price or current bona fide competitive bid and offer quotation can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom (see rule 15c3-1 subparagraph (c)(11)).

- o Securities which cannot be offered or sold because of other arrangements, restrictions or conditions applicable to the securities or to the company.

168. For financial statement purposes, trading and investment positions should be reported as follows:

- o Marketable securities, options, and spot or future commodities items should be valued at current market value.

- o Securities and other investments with no ready market should be valued at fair value as determined by the management of the broker or dealer.[5]

- o The increase or decrease in unrealized appreciation or depreciation resulting from the foregoing treatments should be included as part of revenue in the income statement.

- o Deferred income taxes should be provided for the difference in the reporting of these accounts for financial and tax purposes.

169. The current market and fair value concept recognizes that investment securities and other investments that are marketable or have no ready market, appreciate or depreciate depending upon the earnings record of the companies themselves or as the market or other economic conditions dictate. Accordingly, the broker or dealer should account for its decisions to purchase, hold, or sell a particular investment during the period under review. The current market and fair value concept provides the most effective means of measuring the investment decision of the management of the broker or dealer.

170. The broker's or dealer's interest (assuming such interest is not merely contingent) in underwriting or joint accounts with others for issued securities should be included with the investment accounts. Where part of the joint accounts are carried by other brokers or dealers, the interest of the brokers or dealers being reported on should be determined and classified as above with a contra liability to, or receivable from, the carrying broker or dealer. For joint accounts carried by the broker or dealer in which the broker or dealer has an interest, the applicable portion of the securities, options, and spot or future commodities items is normally included in the appropriate dealer or investment classifications, and the other parties' interests in the ledger balance are included in receivables or payables. Specific requirements regarding joint accounts are included in the instructions to Form X-17A-5.

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[5]Investments of 50 percent or less of the voting stock of an entity that meets the criteria of APB Opinion no. 18, <u>and</u> that are made for long-term <u>operating</u> purposes, should ordinarily be carried on the equity basis. Investments of this type are usually made to provide facilities or services to the broker or dealer. The emphasis here is on the long-term operating nature of this type of investment.

171. Many brokers or dealers that act as principals have contractual commitments including underwriting, when-issued, when-distributed, and delayed delivery contracts. Appropriate disclosure should be made of these commitments, and provision should be made for losses; and for delayed delivery contracts, gains should also be recorded. (See chapter 5 of this guide, "Government Securities.")

172. Securities owned which are sold by the broker or dealer under repurchase agreements involving the same or substantially identical securities are treated as financing transactions and not as sales of long positions. Securities owned which are sold by the broker or dealer under repurchase agreements involving the same or substantially identical securities should be reported with investment accounts, at market value, in the Statement of Financial Condition. The amount of the repurchase agreement should be reflected as a liability.

CHAPTER 3

INTERNAL ACCOUNTING CONTROL AND RELATED REPORTING REQUIREMENTS

General Aspects

173. Statement on Auditing Standards no. 1, section 320.28, describes internal accounting control as follows:

> Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:
>
> a. Transactions are executed in accordance with management's general or specific authorization.
>
> b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
>
> c. Access to assets is permitted only in accordance with management's authorization.
>
> d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

174. Many activities of a broker or dealer are unique to that industry; therefore, many internal accounting controls are unique. Such controls are concerned with receiving, delivering, pledging, borrowing, lending, transferring, and maintaining custody of securities; maintaining customers' accounts, including extending credit under the regulations of the Board of Governors of the Federal Reserve System; and transactions with other brokers, dealers and organizations involved in clearing or settling securities transactions.

Specific Controls

175. Certain controls unique to a broker or dealer, such as procedures to provide reasonable assurance of compliance with rule 15c3-1 and 15c3-3, are discussed in the following paragraphs. Controls that are similar to those of industrial and other commercial enterprises are not discussed.

176. Although the following discussion deals with specific controls related to the securities industry, it is general in nature and does not necessarily reflect the actual operations of every broker or dealer.

177. Internal accounting control is particularly important in the following areas:

- Securities
- Customers' accounts
- Transactions with other brokers or dealers
- Electronic data processing

These areas are discussed in the following paragraphs.

Securities

178. The objectives of internal accounting control over securities are to provide reasonable assurance that securities are safeguarded, accounting records are reliable, and related regulatory requirements are met. With respect to control over securities, the following are important internal accounting control features:

- Certificate numbers should be recorded for all securities received and delivered. This is sometimes accomplished by microfilming such securities.
- Securities received should be examined for negotiability (that is, endorsement, signature, and guarantee) and for completeness (that is, coupons and warrants) before they are placed in the active box or vault.
- Securities received from customers registered in other than the customer's name should be accepted only if proof of ownership is provided.
- A limited number of employees should be authorized to execute or guarantee assignments.
- Facsimile signature devices, if used, should be controlled.
- When securities are shipped against payment, a designated employee who does not handle securities or cash should determine that payment is received.
- Physical controls should be maintained over securities on hand. Access to areas containing securities should be restricted to authorized employees. Access to security vaults should be permitted only in the presence of two or more authorized employees.
- Customers' fully paid for and excess margin securities should be noted in the records of the broker or dealer as securities

required to be in physical possession or control in accordance with rule 15c3-3. If such securities are not in possession or control, adequate records should be maintained in order to determine the location of such securities and to initiate action to bring them into possession or control within the time period set forth in the rule.

- SEC rule 17a-13 requires that certain brokers and dealers must, at least once in each calendar quarter, physically examine and count all securities held and account for all other securities subject to the broker's or dealer's control or direction, but not in his physical possession. The results of such count and verification should be agreed to the securities record, with all differences noted in accordance with the rule and followed to a conclusion, where appropriate (see paragraph 97).

- Movements of securities should be balanced daily, and responsibility for the clearance of out-of-balance positions should be assigned to specific individuals who have no other duties with respect to all aspects of securities processing.

- Securities positions (and related ledger amounts) in suspense accounts should be investigated and resolved on a timely basis.

Customers' Accounts

179. The objective of internal accounting control over customers' accounts is to provide control over the opening and maintaining of customers' security and commodity accounts. Various procedures are followed by brokers or dealers, some of which are required by regulatory authorities. These procedures include the following:

- New accounts should be approved by appropriate personnel. In addition, the account file should contain appropriate documentation concerning the essential facts relative to each customer. For example, if the customer is a corporation, the file should indicate that the person from whom the orders are accepted is duly authorized by the corporation to act on its behalf. Such documentation and related account supervision procedures are referred to as the "know-your-customer" rules. Special documentation may also be required for other accounts, such as for all customers who wish to trade options or customers who are nonresident aliens.

- Margin customers should sign agreements authorizing the broker or dealer to use their non-fully-paid-for securities to finance their unpaid balances by borrowing money from banks or by loaning their non-fully-paid-for securities to other brokers or dealers. Such agreements are referred to as "hypothecation agreements."

- All accounts should be in the name of the customer unless the broker or dealer has received a written statement signed by the customer attesting to his ownership of an account in any other name, symbol, or number.

- Letters should be mailed to customers requesting confirmation of changes in addresses. Some brokers or dealers mail confirmation requests to the customers' last known and current addresses.

- Statements should be mailed to customers periodically (at least quarterly) unless a customer has specifically requested, in writing, that the statement not be mailed.

- Procedures should be in effect to insure that the customers' statements are in agreement with the margin and security records.

- Written authorization should be required from each customer for whom the broker or dealer carries a discretionary account. Every trade in the discretionary account should be approved. The person delegated the responsibility to approve should not also exercise discretionary authority. An advice should be mailed to the discretionary account customer on the date each trade is executed.

- Separate identification should be maintained for the accounts of all partners, officers, employees, and their known relatives so that transactions in such accounts can be reviewed by an appropriate employee.

- Written approval for the opening of an account should be obtained from the employer of an employee of another broker or dealer.

- Payment of funds or withdrawal of securities from customers' accounts should not be allowed without the proper authorization of appropriate margin department personnel.

- Margin records should be reviewed periodically by an employee who has no duties in connection with them to determine that the minimum margin requirements of the firm are being maintained.

- The margin department of a broker or dealer should have a system to prevent violations of regulation T and similar regulations dealing with the extension and maintenance of credit. Procedures should be in effect to see that all necessary margin calls are made and followed up.

- There should be appropriate segregation of duties and rotation of personnel in key control areas.

Transactions With Other Brokers or Dealers

180. The following should be considered with respect to transactions with other brokers or dealers:

- The details of fails to receive, fails to deliver, securities loaned, and securities borrowed should be agreed periodically to the securities record in accordance with rule 17a-13. In addition, the respective amounts receivable or payable should be agreed to the related general ledger control accounts.

- Aging schedules of fail-to-receive and fail-to-deliver transactions should be maintained currently.

- For accounts carried by other brokers, such as omnibus accounts, the details of transactions should be agreed daily and reconciled at least monthly, and there should be appropriate responsibility for resolving any differences.

Electronic Data Processing

181. Since the definition and related basic concepts of internal accounting control are expressed in terms of objectives, they are independent of the method of data processing used; consequently, they apply equally to manual, mechanical, and electronic data processing systems. However, the organization and procedures required to accomplish those objectives may be influenced by the method of data processing used.

182. SAS no. 3, "The Effects of EDP on the Auditor's Study and Evaluation of Internal Control," discusses EDP accounting control procedures. Paragraph 2 of SAS no. 3 states, in part,

> Because the method of data processing used may influence the organization and procedures employed by an entity to accomplish the objectives of accounting control, it may also influence the procedures employed by an auditor in his study and evaluation of accounting control to determine the nature, timing and extent of audit procedures to be applied in his examination of financial statements.

183. The independent auditor should be familiar with the general controls and application controls described in SAS no. 3.

Reporting on Internal Accounting Control by Independent Auditors

184. Rule 17a-5(g) discusses the objectives of an examination by independent auditors. They include obtaining a reasonable assurance that material inadequacies existing at the date of the examination in the accounting system, internal accounting controls, and procedures for safeguarding securities would be disclosed. Rule 17a-5(g) also lists as a specific objective, a review of the practices and procedures followed by the client in

(i) making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e);

(ii) making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by rule 17a-13;

(iii) complying with the requirement for prompt payment for securities of section 4(c) of regulation T of the Board of Governors of the Federal Reserve System; and

(iv) obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

These objectives recognize the regulatory concern for safeguarding customers' property held by the broker or dealer.

185. The SEC requires the independent auditor to issue a report on internal accounting control. For this purpose, the SEC will accept a report that (a) expresses an opinion on the adequacy of the practices and procedures listed above in relation to the definition of a material inadequacy as stated in rule 17a-5(g)(3) and (b) discloses material weaknesses in internal accounting control, including procedures for safeguarding securities, found as a result of a study and evaluation made to determine the scope of auditing procedures. SAS no. 30, "Reporting on Internal Accounting Control," gives guidance in paragraphs 54 through 59 on reports based on criteria established by regulatory agencies, and states that an agency may publish specific criteria for the evaluation of the adequacy of internal accounting control for its purposes. Rule 17a-5(g)(3) states that a material inadequacy expected to be reported includes any condition which has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to

(i) inhibit a broker or dealer from promptly completing securities transactions or promptly discharging his responsibilities to customers, other brokers, dealers or creditors;

(ii) result in material financial loss;

(iii) result in material misstatements of the broker's or dealer's financial statements; or

(iv) result in violations of the Commission's record-keeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in parts (i), (ii) or (iii) of this subparagraph (3).

SAS no. 30, paragraphs 47 through 54, gives guidance on reports on internal accounting control based solely on a study and evaluation made as part of an audit, including reports for the use of specified regulatory agencies. SAS no. 30 defines a material weakness in internal accounting control as a condition that "results in more than a relatively low risk of errors or irregularities in amounts that would be material in relation to financial statements." As used below, the term material inadequacy encompasses either a material weakness in relation to internal accounting control or a material inadequacy in relation to the practices and procedures in SEC rule 17a-5(g)(1) or regulation 1.16 of the Commodities Exchange Act, as appropriate.

186. In compliance with the rules of the SEC, the auditor is required to review and make appropriate tests of the accounting system, internal accounting controls, and procedures for safeguarding securities for the period since the prior examination date. If, based on the review and tests of compliance, no material inadequacies are found to exist with respect to any of those matters, the auditor should state that in his report on internal accounting control. However, if material inadequacies are found to exist during the year-end work or in the performance of interim work, the report should disclose the nature of the inadequacies and the corrective action proposed to be taken or already taken by the broker or dealer. The auditor should follow the guidance in paragraph 42 of SAS no. 30, which states that "if management has implemented control procedures to correct the weakness, the accountant should not refer to this corrective *action (in his report) unless he has satisfied himself that the procedures are* suitably designed (to correct the weakness) and are being applied as prescribed."

187. The auditor's responsibility with respect to material inadequacies is described in rule 17a-5(h)(2) as follows:

> If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal accounting control, procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he shall call it to the attention of the chief financial officer of the broker or dealer, who shall have a responsibility to inform the Commission and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d) and (f) of Rule 17a-11. The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegraphic communication within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if he disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in Rule 17a-11. Such report from the accountant shall, if the broker or dealer failed to file a notice, describe any material inadequacies found to exist. If the broker or dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.

188. A determination of a material inadequacy may, in many instances, require completion of audit procedures in a particular area; appropriate review at the decision-making level by management and the independent auditor; and possible consultation with counsel. While it is expected that a determination in this context involves a contemplative process, the length and complexity of the deliberations should depend on the circumstances and be completed in the shortest time possible.

189. The report shown in exhibit I in the Financial Statements Exhibits section in this guide is appropriate when the auditor has completed his examination of the financial statements. Pursuant to rule 17a-5(d), the report should be filed along with the annual audit report. SEC rule 17a-5(c)(2)(iii) provides that when the independent auditor has commented on a material inadequacy, the broker or dealer must include in the Statement of Financial Condition furnished to customers a statement that a copy of such report is currently available at the principal office of the SEC in Washington, D.C. and at the regional office of the SEC for the region in which the broker or dealer has its principal place of business. The report shown as exhibit J in that section in this guide should be used if an examination has not been completed and if the independent auditor disagrees with the notification made by the broker or dealer, or if the broker or dealer has failed to make the required notification. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.

190. Regulation 1.16 of the Commodity Exchange Act also requires a report describing any material inadequacies found to have existed since the date of the previous audit. If the audit did not disclose any material inadequacies, the report must so state.

191. Regulation 1.16 specifies that the audit must include reviews of (a) the practices and procedures followed in making the periodic computation of the minimum financial requirements pursuant to regulation 1.17 of the Commodity Exchange Act, (b) the daily computations of segregation requirements according to section 4(d)(2) of the act and the regulations thereunder, and (c) the segregation of funds based upon such computation.

192. Regulation 1.16 defines a material inadequacy in much the same way as does rule 17a-5. However, it changes the fourth condition of inadequacy to any condition that could reasonably be expected to result in violations of the Commodity Futures Trading Commission's (CFTC) segregation, record-keeping, or financial reporting requirements to the extent that the broker's or dealer's ability to promptly complete transactions or discharge its responsibilities to customers or other creditors would be inhibited, or to the extent that a material misstatement of the broker's or dealer's financial statements and schedules could result.

193. If the auditor discovers a material inadequacy during either his preliminary or final work, he must call the inadequacy to the attention of the broker or dealer, who must then inform the CFTC by telegraphic notice within three business days. A written report must be sent to the CFTC within five business days, stating what steps have been and are being taken to correct the material inadequacies. The broker or dealer also must furnish the independent public accountant with a copy of the telegraphic notice within three business days. If the accountant does not receive a copy of the notice or if he disagrees with the statements in it, he must inform the CFTC and the self-regulatory organization within the three business days.

194. Exhibit K of the Financial Statement Exhibits section in this guide shows the report to be used by the independent auditor when filing his report to the CFTC.

CHAPTER 4

EXAMINATIONS

Prescribed Audit Objectives

195. Rule 17a-5 discusses the objectives of the annual examination of the financial statements of a broker or dealer as follows:

> (1) The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding securities including appropriate tests thereof for the period since the prior examination date. The audit shall include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, changes in financial position, and the Computation of Net Capital Under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers Under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3. The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities and (d) the practices and procedures whose review is specified in (i), (ii), (iii) and (iv) of this paragraph would be disclosed. Additionally, as specific objectives, the audit shall include reviews of the practices and procedures followed by the client:
>
> (i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e);
>
> (ii) in making the quarterly securities examinations, counts, verifications and comparisons and the recordation of differences required by Rule 17a-13;
>
> (iii) in complying with the requirements for prompt payment for securities of section 4(c) of regulation T of the Board of Governors of the Federal Reserve System; and
>
> (iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3. Such review shall include a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to Rule 15c3-3(d)(4).

(2) If the broker or dealer is exempt from Rule 15c3-3, the independent public accountant shall ascertain that the conditions of the exemption were being complied with as of the examination date and that no facts came to his attention to indicate that the exemption had not been complied with during the period since his last examination.

Extent and Timing of Auditing Procedures

196. With respect to the extent and timing of auditing procedures, rule 17a-5 also states, in part, the following:

> The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (g) above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

197. Certain auditing procedures may be performed at a date other than the date of the financial statements, including work relating to security counts and related confirmations.[6]

198. In determining the extent of procedures to be performed, the auditor should consider the materiality of the item in question and the possible effect of a misstatement in the financial statements and related schedules. Additionally, the audit scope for review and testing of procedures relative to net capital, quarterly security counts, and compliance with regulation T and rule 15c3-3 should be sufficient to provide reasonable assurance that any material inadequacies existing at the examination date would be disclosed as prescribed in rule 17a-5. Chapter 3 of this guide gives the SEC's definition of a material inadequacy.

Nature of Auditing Procedures

199. Certain auditing procedures unique to an examination of a broker or dealer are discussed in the following paragraphs. Auditing procedures that

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[6] The proposed Statement on Auditing Standards entitled Timing of Substantive Tests gives guidance on factors to be considered if work is performed at a date prior to the date of the financial statements.

are similar to those for examinations of industrial and other commercial enterprises are not described in this guide. Nothing in the following discussion should be construed as limiting the independent auditor's examination or prohibiting the omission of any procedures he deems unnecessary in the circumstances.

200. Preliminary Considerations. Before starting the engagement the independent auditor should refer to the guidance provided by SAS no. 22, Planning and Supervision. At the start of the examination, to avoid confusion and to insure a minimum amount of inconvenience to the client, it is desirable for the auditor to meet with the client's operating personnel to discuss the examination. Before undertaking the examination, the auditor may wish to make a study of the physical layout of the client's principal office, the organization of the employees' duties, and other similar factors. If the client uses EDP in its accounting systems, whether the application is simple or complex, the auditor needs to understand the entire system sufficiently to enable him to identify and evaluate its essential accounting control features. Situations involving the more complex EDP applications ordinarily will require that the independent auditor apply specialized expertise in EDP in the performance of necessary auditing procedures.

201. Review of In-House Data Processing Operations. If the client uses in-house computer systems, the independent auditor should evaluate the internal accounting control over such systems. In conducting the review of EDP controls, the auditor should be concerned with input, processing, and output controls. He should refer to the guidance provided by SAS no. 3, The Effects of EDP on the Auditor's Study and Evaluation of Internal Control, when developing the program for this review.

202. Review of Electronic Data Processing Service Centers. The use of an EDP service center may improve internal control because of the separation of responsibilities inherent in the third-party status of the service organization. However, the requirements for the auditor to review the input/output controls in effect at the broker or dealer are in no way diminished.

203. The work to be done by the auditor in reviewing controls at the service center will depend on the facts and circumstances in each case. If, for example, he is able to examine the output of the service center and to satisfy himself that the broker or dealer is able to check the daily output throughout the year, it may not be necessary to perform any further review of the service center's processing controls. However, the auditor should inquire about problems relating to system continuity or data file security due to inadequate equipment or program backup, or poor control at the service center.

204. If the auditor determines that a review of the controls at the service center is required, he may use the report on the system of internal accounting control of the independent auditor of the service center for that purpose. If such report is not obtained and the processing is considered significant in relation to the overall information processing of the broker or dealer, he may consider performing such a review. With respect to such a review, reference should be made to the AICPA industry audit guide, Audits of Service-Center-Produced Records.

Examination of Stock Record Positions

205. The independent auditor's objective in examining stock record positions is to determine that positions on the stock record, including securities, debt instruments, and options, are balanced and to determine which positions should be subjected to auditing procedures, where appropriate. Audit evidence for stock record positions may be obtained by physical inspection or confirmation or a combination of both.

Securities in Physical Possession

206. The independent auditor would normally account for securities in physical possession by counting, or as part of the quarterly security count requirements of rule 17a-13, by observing and testing the broker's or dealer's procedures for physical inspection.

207. If the auditor observes the broker's or dealer's security count, he should ascertain that procedures employed result in a complete and accurate count. He should review the procedures used; review the execution of these procedures; and, to the extent necessary, perform test counts and appropriate follow-up procedures.

208. If the auditor tests physical securities on hand at interim dates, he may want to be involved in the quarterly count made on the date closest to the date of the financial statements. This involvement could be limited to discussions with the broker or dealer and to a review of the procedures to be followed during the count to determine if they are consistent with those which the independent auditor has previously reviewed, tested, and determined to be reasonable. Depending on the significance of the security count (for example, considering volume of securities on hand and/or involvement of internal auditors), the auditor may want to be present during portions of the count to obtain satisfaction that those procedures are being followed and that there has been no change from the procedures tested. The auditor should be familiar with the guidance provided by SAS no. 9, The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination.

209. The independent auditor should inquire about the results of the security count and determine that there are no material unresolved differences. If there are such differences the auditor should satisfy himself to the extent considered necessary as to the reason, nature, and ultimate disposition of the differences and their impact on the financial statements and other regulatory reporting requirements. The effect on the financial statements of resolved differences should be considered also.

Securities in for Transfer, Exchange or Redemption

210. A broker or dealer, particularly one that engages in a substantial volume of transactions, may have a separate transfer department or division to handle securities held for transfer. The securities handling procedures are substantially the same for all brokers or dealers and do not vary materially

with the size or plan of organization. Securities in for transfer, exchange or redemption consist of the following:

- Securities on hand pending preparation of instructions for transfer of title, exchange or redemption.
- Securities on hand awaiting processing for delivery or routing to securities boxes.
- Securities on hand that are not in negotiable form because legal documents, such as those necessary to qualify one to act as executor, administrator or guardian, are not available. These securities are frequently referred to as "legal" securities.
- Securities delivered to local transfer agents for transfer of title, exchange or redemption and for which window tickets or receipts are held.
- Securities sent to out-of-town transfer agents or to corporate issuers for transfer of title, exchange or redemption. Copies of transmittal correspondence or multicopy transfer instructions should be available for inspection.
- Securities receivable from other brokers or dealers that have initiated transfer-of-title procedures. This situation occurs when the receiving broker receives a certificate or certificates for more shares than required and thus is having the excess shares transferred to the name of the delivering broker or dealer.
- Securities in the process of being transferred through DTC or any other depository services.

211. The first three of the above types of securities (that is, securities on hand) should be subjected to auditing procedures similar to those for other securities in physical possession. The last four of the above types of securities may be accounted for, to the extent the auditor deems necessary, by correspondence with the transfer agents, the corporate issuers, or the other brokers or dealers, or by physical examination of the securities when they are returned to the broker or dealer. In determining the procedures to be applied, the auditor should consider the length of time such items have been in transfer. Examination of the securities when returned implies that it is reasonable to assume that such returns represent evidence that the securities were held by the transfer agent on the registration date.

Securities Held at Depositories

212. Brokers or dealers generally assign one individual or department the responsibility for balancing the positions with depositories and clearing organizations. The independent auditor should consider obtaining directly from these organizations, copies of a statement of security positions of the broker

or dealer as of the date of the security count. The broker or dealer should prepare a reconciliation of positions held by these organizations, which the auditor should test by reference to his copy of the statement. For the continuous net settlement accounts, there is a direct relationship between the net market value of the securities to be settled and the money to be settled. This relationship should be reviewed and any differences explained. Since most of the securities maintained by many brokers or dealers will be located at one of these organizations, it is important that the independent auditor consider the internal accounting controls in effect at such organizations. He may do so by obtaining the most recent report on the organization's system of internal control issued by that organization's independent auditors. (See SAS No. 44, Special Purpose Reports on Internal Accounting Control at Service Organizations.)

Securities Failed-to-Receive and Failed-to-Deliver, Securities Borrowed and Loaned, and Securities Held as Collateral for Bank Loans

213. The independent auditor would normally test the positions of securities failed-to-receive, failed-to-deliver, borrowed and loaned and held as bank loan collateral by confirmation with the other party to the transaction. The extent of the confirmation procedures should be based on the auditor's judgment concerning internal accounting control, size of accounts, relationship of money balance to security value and types of errors or irregularities that have occurred.

Securities Held by Branch Offices

214. The auditor should inquire about securities held by branch offices and, if material, should consider whether such securities should be inspected by him; or, he should determine whether a review of the broker's or dealer's procedures for controlling and accounting for securities at branch offices would be sufficient.

Securities Position Differences

215. All differences disclosed through the comparison of counts and confirmations with the records of the broker or dealer should be resolved by the broker or dealer, and any adjustments should be reviewed by the auditor as considered necessary.

Examination of General Ledger Accounts and Balances

216. The independent auditor's examination of general ledger accounts and balances includes an examination and review of the following:

- Customer's accounts

- Trading and investment accounts

- Good-faith deposits
- Capital accounts
- Subordinated accounts and borrowings
- Dividends receivable or payable
- Unclaimed dividends, coupons, and securities
- Exchange memberships
- Income, expenses, and other credits and charges
- Open contractual agreements
- Unsettled principal transactions

217. Customers' Accounts. The independent auditor normally should confirm account positions and balances, either by positive or negative requests or a combination of both. The type and extent of confirmations used should be based on the auditor's judgment in the particular circumstances. Statistical sampling techniques may be appropriate if there are many accounts. In selecting customers' accounts for confirmation, the auditor must consider the security positions in such accounts as well as the ledger (money) balances; he also should consider confirming some accounts with zero balances. In some instances, such as a request by the client, confirmation of all customer accounts is appropriate. In such cases, the auditor should perform the procedures discussed in the following paragraph only on those accounts that he would have selected for confirmation. For guidance, the auditor should refer to SAS no. 1, section 331.

218. When the auditor sets out to confirm customer accounts by means of positive requests, he should generally follow up with second requests to those accounts not replying. The auditor should consider employing such alternative procedures that are practicable under the circumstances.

219. The auditor also should review the customer accounts for evidence of undermargined, partly secured, or unsecured conditions which may affect the net capital computation under rule 15c3-1 and the reserve and possession or control requirements of rule 15c3-3, as well as the collectibility of accounts. In performing such a review, it may be helpful to obtain an "equity run" which is a report that indicates for each customer account, the ledger balance and the market values of all securities positions in the customer account.

220. In performing his work in the customer area, the auditor should review the broker's or dealer's practices and procedures established to comply with regulation T of the Board of Governors of the Federal Reserve System and rules 15c3-1 and 15c3-3 of the SEC.

221. Trading and Investment Accounts. The independent auditor should ascertain that the trading department position records are in agreement with

or have been reconciled to the stock record. In addition, he should test the valuation of such securities. Securities traded are valued at market, which is either the closing price for listed securities on the date of the financial statements or--in the event that no transactions occurred on that date--at the appropriate closing bid or asked prices, in accordance with the company's established procedures.

222. Market prices for securities regularly traded are obtained from financial journals or other sources. The sources should be clearly indicated in the working papers. Quotations may not be available for exempted securities and securities not actively traded. In such cases, the auditor may obtain prices for such securities from the trading department of the broker or dealer being examined; however, he should test material items independently with other brokers or dealers having knowledge of the particular security or other appropriate sources.

223. Market quotations may not be available for all securities. In this case, fair value would ordinarily be determined by management. The independent auditor does not function as an appraiser and is not expected to substitute his judgment for that of the management of the broker or dealer; rather, he should review the information considered by management and ascertain that the procedures followed are reasonable in the circumstances. The valuation of municipal bonds is of particular importance to the auditor. In most cases, market quotations are not available for bonds issued by political subdivisions and the auditor must evaluate the methods and bases underlying the valuation of such bonds. The pricing of municipal bonds is not an exact science and varies depending on the financial and other information about the political subdivision and the specific bond in question. Factors such as the rating on the bond, the coupon rate, the prime lending rate, any redemption provisions, the maturity date, and so forth, are all important in determining the value of the municipal bond.

224. Municipal bonds for which market quotations are not readily available or for which market quotations are unreliable should be valued at fair value as determined by management. For those determinations, management may authorize the use of "matrix pricing" or pricing based on reliable quotations of similar securities. The mathematical technique known as matrix pricing is used to determine securities valuations based on market data available with respect to the issue and similar issues without exclusive reliance on quoted market prices. If management or its pricing service uses matrix pricing, the auditor's understanding of the procedures should be sufficient to satisfy him that the procedures produce a reasonable and fair valuation. He should perform those test calculations he deems necessary in the circumstances. As partial substantiation for the valuation of municipal bonds, the auditor may also wish to review purchases or sales made shortly before and after the valuation date being tested. Or, he may request a valuation from other brokers or dealers or independent pricing services.

225. If the auditor is unable to apply auditing procedures to obtain reasonable assurance as to the fair values of municipal bonds or securities that are not readily marketable, he may need to modify his opinion because of a scope limitation. See the Notes to Exhibit A in the Financial Statements Exhibits section of the guide.

226. Good-Faith Deposits. Normally, good-faith deposits accompany bids to purchase new issues of securities. The deposit and the related commitment normally can be confirmed at the same time. The broker or dealer may be acting as the manager of a group making a bid for a new issue of securities and, in such cases, the other participating members usually deposit proportionate amounts of the required deposit with the managing dealer. In these instances, the auditor may consider requesting his client, the managing dealer, to confirm in writing the amount of its deposit. He may also request that the participants confirm the amount of their deposit in writing.

227. Capital Accounts. For an incorporated broker or dealer, the auditor's procedures relating to capital accounts normally are the same as those for other commercial corporate clients and are not discussed in this guide. For a partnership, the auditor should examine the partnership agreement. In addition, he should determine the extent to which securities or equities in the partners' security or commodity accounts may be included in partnership equity or in net capital, or are otherwise available to the creditors of the firm.

228. Subordinated Accounts and Borrowings. The independent auditor should obtain satisfaction concerning subordination or secured demand note agreements and determine whether they have been approved by the appropriate regulatory bodies. This may be done by direct confirmation. Additionally, he should determine by confirmation the expiration dates of the agreements, the extent of the amount subordinated, any limits as to those amounts, and the exact nature of the liability to the subordinating party. This information is necessary to determine the carrying value of these accounts and the appropriate treatment under net capital rules.

229. Dividends Receivable or Payable. Dividends receivable in cash or securities should be analyzed and reviewed as to age and collectibility and, if material in amount, should be confirmed, if deemed appropriate. Most brokers or dealers do not record dividends receivable or payable on "long" or "short" stock positions on the record date. The recording is not made until the payable date of the dividend, which can be a few days or several weeks after the record date. This practice may result in understatements of assets and income (long positions), or liabilities and expense (short positions), when a dividend record date and payable date straddle the date of the financial statements. The auditor should review the procedures for recording dividends receivable and payable and consider whether any unrecorded amounts are material.

230. Unclaimed Dividends, Coupons and Securities. The auditor should review the procedures followed by the broker or dealer for recording material transactions in accounts for unclaimed dividends, coupons and securities. Detailed accounts maintained for unclaimed items should be compared with control accounts. Charges against unclaimed items can be examined on a selected basis and compared to claims or correspondence, particularly older items. The procedures of the broker or dealer for compliance with state laws should be reviewed. Market action with respect to underlying items may give rise to contingent liabilities and net capital charges, and such activity should be reviewed.

231. Exchange Memberships. The ownership of exchange memberships can be confirmed by direct correspondence with the exchange. An exchange membership is normally registered in the name of an individual; however, it is ordinarily an asset of the broker or dealer if it is held by the broker or dealer under an A-B-C agreement, or if its use has been contributed to the broker or dealer under a subordination agreement.

232. Under an A-B-C agreement, the member agrees that the member or his legal representatives will comply with one of the following options if the member organization is dissolved, if the member ceases to be a participant in the organization, if the member dies, or if other contingencies occur:

- Retain the membership and pay to the broker or dealer the amount necessary to purchase another membership;
- Sell the membership and pay the proceeds over to the broker or dealer; or
- Transfer the membership for nominal consideration to a person who is designated by the broker or dealer and satisfactory to the exchange.

233. It is not unusual for a broker or a dealer to have more than one membership on a particular exchange. The propriety of considering exchange memberships as assets of the broker or dealer should be evaluated by reference to partnership agreements or other documents of the broker or dealer. Also, the auditor should satisfy himself as to the propriety of the carrying value of the memberships and whether the carrying value has been permanently impaired.

234. Income, Expense and Other Credits and Charges. As in other industries, the procedures followed in examining income and expense accounts will depend on the materiality of the items and the system of internal accounting control. The auditor should consider such matters as stock exchange volume, the broker's or dealer's share of the market, changed conditions (such as volume of new securities offerings), changes in character of the broker's or dealer's business, and trend of securities prices. A discussion of this comparative data with the management of the broker or dealer may highlight areas that require additional auditing procedures.

235. The auditing procedures for the substantiation of many of the income and expense items such as interest, dividends, employee compensation, occupancy, communications, promotion and taxes are similar to those for other industries and thus are not discussed. A sample of trading and investment profit and loss transactions should be tested, and the auditor should consider whether trading and investment inventories are valued at market. Any market adjustments should be reflected in current earnings. Calculations of commission income should be tested and may be analyzed in relation to trading volumes or to compensation of registered representatives. Provisions for uncollectible accounts and for potential loss on aged fails, aged transfers, aged dividends receivable, and security shortages should be analyzed and reflected in the proper accounting period. Accounts reflecting gains or losses from closed-out security differences should be reviewed, and consideration should be given to

the effect of possible claims arising from closed-out "long" differences (overages). Accruals should be tested to determine that they are made in the appropriate accounting period for such items as investment advisory fees, amounts due to and from syndicate account managers and professional fees. The auditor should determine that accruals have been properly made for commission income and trading profits and losses resulting from unsettled transactions.

236. Open Contractual Commitments. Contractual commitments that are normally not recorded in liability accounts include underwriting commitments, when-issued contracts, delayed delivery contracts, endorsements of puts and calls and commitments in foreign currencies.

237. The independent auditor may wish to confirm on a test basis those contractual commitments, other than endorsed puts and calls (the holders of which are unknown). In many cases, the commitments of customers will appear in the accounts of the customers and will be confirmed at the time the accounts are confirmed. In other cases, however, information concerning purchases and sales of securities on a when-issued, delayed delivery or when-distributed basis may not appear in the accounts of customers or in the stock record but instead may be maintained in a subsidiary record (for example, tickets in an open contract file). In such cases, the open contracts may be confirmed in the same manner as other accounts. In some instances when a settlement date (subsequent to the date of the financial statements) has been fixed for an open contract transaction, the broker or dealer will clear the open contract file and enter the transactions on the settlement blotter for the day of settlement. These are not "regular way" transactions and may be confirmed separately; if material, they should be disclosed in a commitments or contingencies note to the financial statements.

238. Another type of contract involves the broker's or dealer's interest in joint accounts in issued or "to be issued" securities carried by other brokers or dealers. In many cases the interest in these security positions is not recorded in the general ledger of the non-carrying member of the joint account. In these cases, there is usually an adjustment recorded in the trial balance to reflect such accounts in the financial statements. Details of the joint accounts may be confirmed in writing with the carrying brokers to the extent the auditor considers it necessary.

239. Unsettled Principal Transactions. These transactions occur when brokers or dealers record transactions on a settlement date basis and maintain material positions in their inventory accounts. If there has been a material change in the inventory value between the settlement and trade dates, the auditor should determine that appropriate adjustments have been made to fairly present the financial position and results of operations.

Examinations of Omnibus Accounts

240. Clearing Brokers. The broker or dealer may perform clearing functions for other brokers (the initiating brokers), and the auditor may confirm those brokers' balances in omnibus accounts. The broker or dealer should explain differences, if any, between the books and confirmation responses, and reconciling items should be traced to supporting documentation.

241. The clearing broker's segregation, transfer, and cashiering operations and controls relating to transactions of the initiating broker should be tested to determine that the instructions of the initiating broker were carried out on a timely basis, in compliance with their agreement, and in accordance with the prescribed rules and regulations of applicable regulatory agencies.

242. In addition, the auditor may want to trace selected trades in the omnibus accounts to underlying documentation furnished by the initiating broker, and perform tests to determine that the clearing fee was determined in conformity with the applicable agreement.

243. Initiating Brokers. The balance in the omnibus account should be confirmed with the clearing broker. Any difference between the confirmation response and the client's records should be traced to underlying documentation. In addition, the auditor should consider testing the computation of the clearing fee for compliance with the related agreement.

Examinations of Fully Disclosed Accounts

244. Carrying Brokers. Since the accounts of the introducing broker's customers are maintained on the books of the carrying broker, as if they were customers of the carrying broker, the auditing procedures applicable to these accounts are the same as for those performed on other customers' accounts. In addition, the auditor should consider testing the fees earned for carrying the other broker's accounts.

245. Introducing Brokers. The auditor should determine that the introducing broker is credited with the appropriate fee for trades generated by its customers. There should be tests of the introducing broker's system for verifying that all trades were executed in accordance with its instructions and that fees were determined in compliance with the applicable agreement. Such tests would ordinarily include comparison of daily trading activity summaries prepared by the carrying broker with memorandums of the introducing broker.

Private Placements

246. The examination of private placement transactions may include a review with management of agreements between the broker or dealer and entities for which the placement of debt or equity securities has been effected. The status of the individual contracts should be reviewed to determine any existing obligations of the broker or dealer that may require disclosure in the financial statements. In addition, the auditor should consider confirming outstanding contractual agreements offsetting customers' commitments to purchase such securities.

Mutual Funds

247. Procedures for examining mutual fund transactions will differ depending on the amount of activity and the method of accounting for customer purchases and redemptions. Few auditing procedures are necessary in cases in which the broker assists a customer in the purchase or redemption of mutual fund shares in the name of the customer. However, when a broker or dealer, acting in a custodial capacity for customers, maintains an active account in its name with one or more mutual funds, certain procedures should be considered. The procedures may include confirming the number of shares held by the mutual funds in the name of the broker and comparing these quantities to safekeeping records of the broker or dealer. Depending on the materiality of open purchases or redemptions, these amounts may also be confirmed.

Refunding Bond Underwritings

248. The independent auditor's concern in examining bond underwritings should not vary from those concerns surrounding regular underwritings and open contractual commitments. However, he should exercise care in determining whether the broker or dealer has met its commitment to the political subdivision to purchase the U.S. Government securities that are to be placed in escrow. Often the U.S. Government securities may not be available in the quantities desired or at the same price as anticipated at the time the underwriting agreement was executed. In such cases, the broker or dealer may sustain losses in satisfying its obligation to the political subdivision.

Computation of Formula for Determination of Reserve Requirement

249. Among other things, rule 15c3-3(e) under the '34 act provides that

> Every broker or dealer shall maintain with a bank or banks at all times when deposits are required or hereinafter specified a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter referred to as the "Reserve Bank Account"), and it shall be separate from any other bank account of the broker or dealer. Such broker or dealer shall at all times maintain in such Reserve Bank Account, through deposits made therein, cash and/or qualified securities in amounts computed in accordance with the formula attached hereto as Exhibit A.

250. Exhibit A of rule 15c3-3 provides a detailed formula for the determination of the reserve bank account requirement. In addition the designated times for the computations are outlined in the rule.

251. The rule also requires a broker or dealer to promptly obtain physical possession or control of all fully paid securities and excess margin securities carried for the account of customers, and it requires the broker or dealer to act within a specified time period when possession or control has not been established.

252. The auditor should review the procedures and controls of the broker or dealer relating to this rule and should perform those tests he considers necessary to satisfy himself that the procedures and controls, including the written documentation, in effect provide reasonable assurance that the broker or dealer is in compliance with the rule.

Report to be Rendered on SIPC Annual Assessment

253. Due to the growth in the amount of funds available to SIPC in recent years, there is no annual assessment other than the annual membership fee of $25.00 currently required nor is there a requirement for a report. Procedures that were applicable to review and report on the SIPC Annual Assessment are given in rule 17a-5(e)(4). The auditor should determine the requirement for a separate report at the time of his examination.

Filing of Reports

254. Rule 17a-5 gives the filing requirements for the annual audited reports. The reports are to be filed with the SEC in Washington, D.C., and the appropriate regional office and with the broker's or dealer's designated examining authority. Upon request, confidential treatment is given for portions of the report.

255. If a broker or dealer finds that it cannot file its report for any year within the specific period without undue hardship, it may file an application with the SEC before the due date of the report and request an extension of time. Notice of such application should also be sent to the designated examining authority. The application should state the reason(s) for the extension, describe the circumstances that are beyond the control of the broker or dealer, and indicate whether there are financial or record-keeping problems or if there are violations of net capital or the requirements of rule 15c3-3. The request should be accompanied by a letter from the independent auditor stating

- o The reasons for the extension request.
- o Whether there is any indication of material inadequacies in the accounting system, internal accounting control, and procedures for safeguarding securities.
- o Whether there is any indication that the condition of the broker's or dealer's records is endangering its ability to supervise its registered representatives and their handling of customer accounts.
- o Whether there is any indication that the broker or dealer is in violation of the net capital requirements specified in rule 15c3-1 or the requirements of rule 15c3-3, or has any significant financial or record-keeping problem.

Brokers or Dealers Exempt From Rule 15c3-3

256. Certain brokers or dealers adhere to the exemptive provisions of rule 15c3-3. In doing so, the broker or dealer is not required to comply with the remaining provisions of that rule, such as computations of amounts required to be on deposit in a "special reserve bank account for the exclusive benefits of its customers," possession and control requirements, and so forth. The detail requirements to be met in order to qualify for such exemption are outlined in rule 15c3-3 and need to be considered in connection with the rule in its entirety. Therefore, it is impractical to describe all such conditions; simply stated, however, to qualify for exemption the broker or dealer may not put at risk any customer's funds or securities.

257. In examining the financial statements of a broker or dealer that is claiming exemption from rule 15c3-3, the auditor should determine under which specific section of the rule the exemption is being claimed, and what controls and procedures are in place to insure compliance with that section. He should then design tests to provide reasonable assurance of compliance during the year and at year-end. In the event compliance has not been met or the controls and procedures are deemed inadequate, the auditor should immediately consider the notification requirements under rules 17a-5 and 17a-11 pertaining to material inadequacies.

258. In reporting on a broker or dealer exempt from rule 15c3-3, the "Computation for Determination of Reserve Requirements Under Rule 15c3-3" and the schedule of "Information for Possession or Control Requirements Under Rule 15c3-3" are inapplicable. In lieu of those schedules, the independent auditor should include a section under which exemption is claimed. With respect to the effect of the exemption on the "Independent Auditor's Supplementary Report on Internal Accounting Control," see footnote 1 to exhibit I in the Financial Statement Exhibits section of this guide.

CHAPTER 5

UNITED STATES GOVERNMENT AND MONEY MARKET INSTRUMENTS

General

259. In addition to securities transactions involving the purchase and sale of corporate equity and debt securities, U.S. Government, federal agency, and money market instruments (commercial paper, bankers' acceptances, and certificates of deposit and various forms of government securities--for example, treasury bills and treasury notes) are becoming increasingly important to many brokers and dealers. Examples of these securities are given below. However, new types of securities are constantly being introduced; consequently, the list is not all-inclusive.

United States Government and Federal Agency Instruments

260. Treasury Bills. Direct obligations of the U.S. Government, treasury bills are issued in maturities of three, six and twelve months, and are traded on an original issue discount basis.

261. Treasury Bonds and Notes. The bonds and notes are direct obligations of the U.S. Government which bear a specific coupon interest rate. Treasury notes may be issued with a maturity of not less than one year nor more than ten years. Treasury bonds have a maturity in excess of ten years.

262. Government Agency Securities. Generally, government agency securities are direct obligations of a specific government agency, which are not guaranteed directly by the U.S. Government. These securities can be issued either on a discount basis or with a specific coupon interest rate. The more common government agency securities include federal intermediate credit banks, banks for cooperatives, federal land banks, federal home loan banks, and federal national mortgage association instruments.

263. Government National Mortgage Association ("GNMA" or "Ginnie Mae") Securities. These securities are fully guaranteed government securities that represent an interest in a specific pool of federal housing administration or veteran's administration mortgages. The investor receives a monthly payment of principal and interest which is guaranteed by GNMA and backed by the full faith and credit of the U.S. Government.

264. Federal Home Loan Bank Mortgage ("Freddie Mac") Securities. FHLB securities are interests in residential conventional mortgages underwritten and owned by the Federal Home Loan Mortgage Corporation, which guarantees monthly payment of principal and interest.

Money Market Instruments

265. Bankers' Acceptances. Bankers' acceptances are drafts that the drawee bank has promised to honor at maturity; they constitute an irrevocable obligation of the bank. Acceptances are created to finance transactions in specific commodities or to facilitate dollar exchange transactions with foreign banks. The drawer of the draft, those who endorse the draft without qualification, and the accepting bank remain contingently liable to the investor for payment at maturity.

266. Certificates of Deposit. Certificates of deposit are obligations of the issuing bank to pay the beneficial holder or bearer the face amount plus interest at maturity.

267. Commercial Paper. Commercial paper consists of short-term promissory notes issued by corporations for any term, normally up to 270 days.

Principal Transactions in U.S. Government, Federal Agency and Money Market Instruments

268. Transactions in U.S. Government and money market instruments are initially recorded at the cost or proceeds. For all such securities, inventory is valued at the current market price each period with the resulting unrealized gain or loss credited or charged to the results of operations. Thus, the current period's income generally includes unrealized gains or losses on mark to market of ending inventory and realized gains or losses on inventory positions liquidated prior to the end of the period. For purposes of income recognition, open transactions executed in the futures commodity markets (that is, futures for treasury bills, bonds, or notes) should be valued at the current market price, with the resulting unrealized gain or loss credited or charged to the current period's results of operations.

GNMA Principal Transactions

269. The following paragraphs relate specifically to GNMA transactions. However, the principles are the same as those for similar securities (for example, federal home loan bank mortgages) which are not specifically addressed below.

270. Description and Trading Practices. When compared to other government-backed securities, GNMA modified pass-through securities are unique in that both a principal amortization and interest are paid on a monthly basis. In addition, each GNMA security has its own identifiable pool number even though such securities usually have the same coupon rate for more than one pool.

271. GNMAs are normally traded on a delayed delivery or forward basis. A time span of up to one year or more can exist between the trade and settlement dates. A very low percentage of trades are executed on a cash or same-day basis. Because of the delayed delivery trading practices, when a transaction is executed on a trade date basis, a stated interest coupon is specified under

a specific pool number to be announced at a future date (TBA designation). The designation of a specific pool number is normally given within twenty days before the settlement date. Prior or subsequent to settlement date, the inventory is assigned to specific customers, where applicable, at the forward purchase or sales price executed with that customer. Mortgage-backed securities can be traded on either a guaranteed or yield maintenance basis. Specific rules on delivery are followed which give specific tolerances on quantity, number of pools, coupon substitutes and so forth.

272. Gain and Loss Recognition. The principles to be followed in the recognition of gain and loss on transactions that have settled or are executed in the futures commodity markets are the same as any other security transactions and are as noted earlier in this chapter. That is, all such positions are marked to market. The detailed information below discusses the accounting and auditing procedures for determining the proper prices to be used to arrive at the current market value and various considerations relating to recognition of gains and losses, balance sheet presentation, note disclosure, internal accounting controls, and credit procedures on forward commitments. In summary, all such transactions should be marked to market on a current basis with the resulting unrealized gains or losses included in the current period's results of operations. The gross amount of such forward (as well as future) transactions should be disclosed in a note.

273. Forward Transactions. Forward transactions ("forwards") are defined as existing trade date commitments with settlement dates subsequent to month-end. They may have a time differential of up to one year or more and are thus traded on a delayed or forward delivery basis. These transactions are normally recorded on memo records, such as a pending or when-issued file, which are confirmed on a regular basis similar to other customer positions that have settled. The accounting for these forward transactions is to recognize the gain or loss on a current basis (that is, by valuing the individual transaction on a current basis). Also, the commitments in total for both purchases and sales should be disclosed in a commitment and contingency note. Such amounts are not recorded on the balance sheet, which is similar to the treatment for future transactions and commodities. Market price in mortgage-backed securities in the forward market is based on its coupon and settlement month. Inventory positions should be defined as the net position in each coupon for each settlement month, and should not be paired or netted if they have different interest rates or settlement months.

274. Standby Agreements. A standby agreement results when one party agrees to "stand by" for a specified time in the future (normally up to one year) to purchase GNMA pass-through securities at a specific price designated on the date of the agreement. The buyer of the standby has the option (one-way) to make delivery or allow the agreement to lapse. The buyer communicates this intent to the prospective purchaser on or prior to notification date--normally, two weeks to one month prior to the settlement date as defined in the agreement. As compensation, a fee which is normally nonrefundable is paid on the date of agreement. In effect, the fee to the potential purchaser is compensation for the option issued to the seller.

275. Since standbys are similar to other options, the accounting should follow other options. Accordingly, all standbys should be marked to market at any month-end. In some cases, obtaining the market value of a standby may be difficult, and an amortized cost based on the time remaining until expiration as well as other factors should be used as a guide in determining market value. In addition, standbys can be paired with other standbys, but only if the terms are identical.

The preceding paragraphs discuss standbys that enable the holder to sell securities (in effect, a put). Similar accounting should be used for standbys that enable the holder to purchase securities (in effect, a call).

276. Transaction Expense. In addition to recognizing gain or loss on a trade date basis, all related expenses (such as salesman's commissions and a provision for potential nonperformance on cancelled trades) should be accrued when the gain or loss is recognized. Establishing reserves for these future commitments should be based upon factors such as the broker's or dealer's historical experience, the amount of open commitments, and the type of customers with whom the broker or dealer has such commitments.

Auditing Procedures

277. The auditing procedures for settled positions on the stock record are similar to other positions (for example, inventory) and should be included in the normal auditing procedures for the stock record. Because most settled positions are held by banks or are with other brokers or dealers and are normally significantly large positions, usually they will be confirmed in total. However, in some circumstances they could be confirmed on a test basis. Unsettled positions (for example, GNMA delayed delivery contracts) should be confirmed also, possibly on a test basis. Consideration should be given to confirming on a test basis with other brokers and dealers to determine if all unsettled trades recognized by the other broker or dealer are included as unsettled positions by the client being audited.

278. The review of client procedures in this area should include the following:

(a) Determination that trades have proper approval.

(b) Determination that trades are with customers or brokers or dealers who have been approved by appropriate client personnel. (This step is especially important for futures commitments.)

(c) Review of the total amount of futures commitments that settle in future periods. (Many brokers or dealers have limits on futures commitments with all customers.)

(d) Determination that signed contracts are being obtained for futures commitments. If signed contracts are not being obtained, the auditor should determine how such commitments are being confirmed.

(e) If applicable, review and evaluation of client procedures for margin deposits.

(f) Review of the broker's or dealer's policies and procedures for evaluating the credit worthiness of its clients.

279. In (b), (c) and (d) above, the emphasis is on considering whether open commitments are with approved institutions or customers and whether such trades have been confirmed. This emphasis is necessary because the auditor needs to consider the likelihood of the transaction being completed. Unlike transactions that settle in five or fewer business days, long-term futures commitments have a greater potential for credit risk. If, for any reason, the transaction cannot be completed by the other institution or broker or dealer, it is important that the client be aware of its total exposure with each customer. Normally, with most futures commitments netting to small positions, there is minimum market risk if all parties perform their obligations; consequently, the emphasis in this area must be on the credit worthiness of the institution or broker or dealer on the other side of the transactions.

280. Auditing procedures used to test pricing would normally include the following:

(a) Review procedures used to price such instruments.

(b) Determine the reasonableness of such prices as they relate to each other.

(c) Review published prices, where possible; in some instances, this will not be a viable procedure.

(d) Review the prices of recent transactions and relate them to the prices being used.

(e) Confirm selected prices with independent market makers other than the client.

(f) Review procedures designed to insure that all principal and interest claims on GNMAs are being made.

281. In addition, as with any other interest-bearing security, accrued interest receivable and payable calculations should be tested.

CHAPTER 6

OPTION TRANSACTIONS

General

282. Options for the purchase or sale of securities are listed and traded on several exchanges and are also arranged off the exchanges by put and call brokers or dealers. A call is an option that entitles buyers to purchase a fixed number of shares of a particular security at a fixed price per share ("exercise price") on or before a fixed date ("expiration date"). A put is an option that entitles the buyer to sell a fixed number of shares of a particular security at a fixed price per share on or before a fixed date.

283. Numerous investment, hedging, and speculating strategies are followed by combining various put and call options with the same or varying numbers of shares, exercise prices, and expiration dates. Commonly used option combinations involving the same underlying security include the following:

- A "straddle," which is a combination of one put and one call identical with respect to security issue, number of shares, exercise price, and expiration date.

- A "spread," which is a combination of one put and one call covering the identical security issue, number of shares, and expiration date. The exercise price for the put is customarily slightly below the current market price whereas the exercise price for the call is customarily above the current market price at the time the option contract is entered into.

- A "strip," which consists of two puts and one call for the same security.

- A "strap," which consists of two calls and one put for the same security.

284. To aid in the understanding of the mechanics of option trading, reference should be made to the glossary in this guide for descriptions of various terms used with respect to options.

285. An active public market has been developed in listed put and call options. For many years, there also has been an over-the-counter (OTC) market in options. The use of the OTC market is presently limited. There are significant differences between listed and unlisted options. The discussion in this section principally deals with listed options, although some specific reference is made in certain areas to unlisted options.

286. Options traded on the exchanges are listed securities and therefore share the following similarities with other securities traded on exchanges:

- Orders to buy and sell options are handled through brokers in the same way as orders to buy and sell shares of stock.

- As in the case of listed shares of stock, exchange-traded option orders are executed on the floor of a national securities exchange where all trading is conducted on an auction basis.

- Market prices are generally readily available. The amount the buyer pays and the writer receives (the "premium") reflects factors such as the remaining life of the option, the difference between the exercise price and market price of the underlying security, and the price volatility and other characteristics of the underlying security.

287. Each listed option is normally for 100 shares of a specific, widely held, actively traded underlying security. The exercise price or "striking" price is the price at which the call option buyer can purchase or the put option buyer can sell the underlying security. All options have a specific expiration date, which is the last day on which the buyer is entitled to exercise his option to buy (call) or sell (put) the underlying security. Expiration dates of certain classes of options (options of the same type covering the same underlying security) and exercise prices are established by the exchanges on which they are traded. The expiration months generally are set at standard three-month intervals.

288. Options are traded in the nearest three of the four expiration months. Thus, for a given stock there may be simultaneous trading in as many as three options with identical exercise prices but with different expiration dates. It is also possible to have trading in options with a common expiration date but with different exercise prices. This difference arises because additional options with higher or lower exercise prices are introduced whenever there has been a significant change in the market price of the underlying security. Exercise prices are generally fixed at $5 intervals for shares trading below $50, at $10 intervals for shares trading between $50 and $100, and at $20 intervals for shares trading over $100. The option expiration date is generally the third Friday in the expiration month.

289. The Options Clearing Corporation (OCC) is the issuer of the options traded on the exchanges and also serves as the clearing agency for option transactions. The OCC is the "obligor" on all option contracts. Once there are matching orders from a buyer and seller and the premium is paid, the OCC becomes the seller to the buyer and the buyer to the seller. This unique and complex rule is fully described in the OCC prospectus. All listed option transactions are required to be cleared through clearing members of the OCC. The transactions cleared by a clearing member are classified as either firm, market-maker, or customer transactions. These classifications are used to determine the margin and collateral obligations for clearing members of the OCC. Collateral obligations are satisfied with customers' securities, letters of credit, or other acceptable collateral.

290. The OCC has organized trading in options so that for every outstanding option there is a buyer and a writer. When a buyer or writer makes an option trade, he is required to indicate whether the trade is in "opening" or "closing" purchase or sale transaction. An opening purchase transaction is a transaction in which an investor becomes an option holder. An opening sale transaction is a transaction in which an investor becomes an option writer. Closing transactions are trades which have the effect of offsetting the trader's pre-existing option position. A closing purchase transaction terminates the obligation of an option writer, and a closing sale transaction liquidates the position as an option holder.

291. Ordinarily, option certificates are not issued by the OCC to evidence the issuance of options. Rather, the OCC maintains a daily record of options issued in each of the accounts of its clearing members, and each clearing member is required to maintain a continuous record of his respective firm, market-makers, and customer positions in options. The ownership of options is evidenced by the confirmations and periodic statements which are received from OCC or its clearing members. If a customer desires documentary evidence of his ownership of an option, the OCC will, upon request, issue a non-negotiable certificate to the clearing member maintaining the customer's account. The certificate, which is issued by the OCC in the name of a clearing member only, indicates that the clearing member is the holder of an option, and provides space for the clearing member to certify to his customer that the option is held for the account of such customer.

292. Because an option purchaser or writer has the ability to enter into a closing transaction, the option originally written may never be exercised. The exercise of an exchange-traded option takes place only through the OCC by the timely submission of an exercise notice by the clearing member acting on behalf of the exercising holder. The exercise notice is then "assigned" on a random basis by the OCC to a clearing member acting on the behalf of a writer of an option of the same series (having the same exercise price, expiration date, and unit of trading) as the exercised option. The member is then obligated to deliver the underlying security against payment of the aggregate exercise price.

293. If the OCC assigns an exercise notice to a member's customer account, the member is required to allocate the exercise notice to a customer maintaining a position as a writer in the account. The member may use any fair and equitable method it chooses in the assignment of customer put and call writers' accounts; however, the method of allocation must be predetermined and reported to the exchange. The exercise settlement date is the fifth business day following the date of the exercise notice assignment.

294. All option transactions on the exchanges are processed through an exchange specialist, a market maker, a floor broker, or a board broker--all of whom clear the transactions through one of the clearing members. The OCC matches the daily trade information and issues (on the same evening) an unmatched trade report to each clearing member, listing clearing member trades for the day for which the OCC did not receive a matching card from another clearing member and all trades reported by other clearing members for which the clearing member submitted no matching trade card. In order to resolve any

differences and submit any corrections or adjustments, the clearing members have until approximately noon of the following day to meet with the other clearing members. Any unmatched trades remaining after these corrections or adjustments are considered void and can be reentered only if both clearing members enter into another trade.

295. Unlisted put and call options normally are written on a standardized contract form. Usually, an individual desiring to purchase an option will contact his broker or dealer and request a market quotation on the cost of the option. The broker or dealer ordinarily will contact an active put and call broker or dealer, who in turn will contact an individual who has previously expressed an interest in selling options of the type required. Assuming that mutually satisfactory terms can be arranged, the option contract will be written, endorsed (guaranteed), and delivered to the purchaser.

296. Unlisted options are written infrequently and may be written on listed or OTC securities, at any price and for any duration. They are generally written at the current market price at the time of entering into the contract, for periods of 30 days, 60 days, 90 days, six months or longer.

297. Certain New York Stock Exchange member organizations operate "option conversion accounts," which are arrangements to cope with the normal imbalance in supply and demand for unlisted call options as contrasted to put options. These arrangements involve the purchase of straddles by an option dealer, who then sells the call and gives the put to a member organization in return for the agreement by the member organization to sell to the dealer a call that generally contains the same contract price as the put. Simultaneously the member organization purchases the related security in the market to "hedge" the call.

Accounting for Options Positions

298. The market or fair value of options fluctuates as the value of the underlying security changes and as the remaining time to expiration decreases. Brokers or dealers carry all securities at market or fair value, and it is appropriate that option positions also be reflected at market or fair value. The cost or proceeds from sales of options are subsequently adjusted to the current market (marked-to-market) or fair value of the options, and as in the case of other securities, any gain or loss is included in the results of operations. The current market value of exchange-traded options generally should be based on the quoted bid and offer prices. The fair value of unlisted options should be determined by the broker's or dealer's management which considers the price of the underlying securities, the liquidity of the market, and time remaining to expiration date. The process of adjusting option positions to market or fair value gives appropriate accounting recognition to the option premium.

Examination of Options

299. Option positions in customer or proprietary accounts of the brokerage concern are carried in the same manner as other securities. (For example,

purchased put or call options are carried as long positions, and sold or "written" options are carried as short positions.) In the case of options, however, the description in the option department records also includes the contract price and date of expiration.

300. In general, the audit of options involves the testing of option positions of customers, market makers, other brokers or dealers and correspondents, and positions with the OCC. It also involves the reviewing of internal accounting controls, the testing of related money balances, the testing of valuation of option positions in proprietary accounts, the confirming of letters of credit and margin deposits, the determination of compliance with margin requirements of NASD and the various exchanges, and the requirements of regulation T of the Federal Reserve Board.

301. The auditing procedures are essentially the same as those used to test other security positions and money balances. Option positions can be tested by confirmation of customer positions and the balancing of positions as reported by the clearing corporation (for listed options), examination of endorsed papers (for unlisted options), confirmation with correspondents, and so forth. Customers' option positions normally are confirmed simultaneously with confirmations of customers' security accounts. Confirmation of security positions and accounts of market makers and other brokers and dealers also can be done along with normal confirmation procedures for those accounts.

302. Listed options normally are traded by a broker or dealer through a correspondent or clearing member of the OCC. Since listed options are not evidenced by a certificate, option positions are carried by the clearing member for the broker or dealer until the option is closed out or has expired. Therefore, street side positions for listed options are confirmed with OCC organizations or the carrying broker.

303. The OCC has established procedures for the daily balancing of all option positions with its members. In the daily balancing of option transactions, it is an extremely important control procedure that a distinction be maintained between opening and closing transactions and that a reconciliation be made of the gross positions. The mere balancing of net positions could result in failure to take timely action to exercise or cover an option position. (For instance, the broker or dealer could fail to exercise a long option whereas the offsetting short position could be called by the holder, thereby resulting in a substantial loss to the broker or dealer.)

304. The audit procedures for clearing brokers should include a review and selected tests of the balancing procedures during the audit period.

305. Unlisted purchased options are evidenced by endorsed "papers" on hand in the "box" or are included in the account of the correspondent broker through which the broker placed its option order. Therefore, the papers are examined, confirmed, and balanced in the same manner as securities.

306. Unlisted sold options can be confirmed in the same manner as a security if the option sale order is placed through a correspondent. If the broker endorses its customers' options and delivers them to the purchasers,

either directly or through put and call brokers, the identity of the purchaser is usually unknown and confirmation may not be possible. The endorsing organization must maintain a record of endorsed papers, and sold options can be tested by comparing them to this record. The customer side of the endorsed option can be confirmed in the same manner as a security and can be balanced against the record of endorsed papers. Since sold options represent commitments of the broker or dealer, the review of controls in this area should encompass the accounting control procedures to record all such transactions.

Margin Requirements

307. With respect to each option for which it represents the writer (short positions), a broker or dealer that is a clearing member of the OCC is required to either deposit the underlying security (in the case of a call) or deposit and maintain specified margins (in the case of a put or call) with the OCC. (Specified margins include cash, U.S. government securities, or bank letters of credit.) The deposit of the underlying security is made with a bank, trust company, or other approved depository under agreements requiring delivery of the security against payment of the aggregate exercise price specified by the call. Such deposits may be made as a commingled deposit for securities of a number of customers. In lieu of the deposit of the securities, a broker or dealer may file with the OCC escrow receipts from approved banks. An escrow receipt is a representation by the issuing bank that a particular customer's securities are on deposit with the bank and will be delivered upon exercise of the call for which the receipt was issued.

308. Regulation T of the Federal Reserve Board and the rules of the NASD and the various securities exchanges of which the broker may be a member impose margin requirements with respect to a customer's position as an options writer; and, in addition, they impose requirements as to the minimum amount of margin that a customer must constantly maintain in a margin account.

309. As a result of the applicable margin requirements, all writing transactions (except in certain limited circumstances) are required to be conducted in a margin account (which ordinarily will be a general account under regulation T). Brokers generally require option writers to enter into margin agreements which give the broker a lien on securities and other assets held in the margin account.

310. The margin requirements are subject to change. Special margin requirements may be imposed from time to time with respect to particular options, particular positions in options (such as certain spread positions), or particular accounts or customers. Under the current provisions of regulation T, options have no loan value in margin accounts.

Net Capital Requirements

311. The net capital requirements of specialists, market makers, board brokers, and registered traders in options are very complex since they relate to various combinations of offsetting positions in options and underlying

securities. The requirements and specific haircut provisions are defined in rule 15c3-1 and in published interpretations which should be carefully reviewed with respect to the specific circumstances and positions of the broker or dealer under examination.

CHAPTER 7

COMMODITY TRANSACTIONS

Regulations

312. On October 23, 1974 the U.S. Congress passed the Commodity Futures Trading Commission Act. The act amended the Commodity Exchange Act and created an independent Commodity Futures Trading Commission (CFTC), which replaced the Commodity Exchange Authority of the U.S. Department of Agriculture. The CFTC regulates all U.S. commodity futures markets including those that previously were classified as "nonregulated." The CFTC is empowered to regulate trading for floor brokers and futures commission merchants (FCMs) who deal for their own accounts as well as for customers. A futures commission merchant is defined as an individual, association, partnership, corporation or trust that is engaged in soliciting or accepting orders for the purchase or sale of any commodity for future delivery on, or subject to the rules of any, contract market. In connection with the solicitation or acceptance of orders, an FCM may accept money, securities or property (or extend credit instead) to margin, guarantee or secure any resulting trades or contracts. The act provides that all goods, articles, services, rights and interests traded for future delivery are regulated and that all domestic commodity exchanges (contract markets) must submit new or amended rules and regulations to the CFTC for approval.

313. Since its inception the CFTC has adopted many new rules and regulations, certain of which bear directly on the independent auditor's qualifications and his responsibility for the examination of the financial statements of brokers and dealers and FCMs. Rules have been adopted which require that an annual financial report submitted by an FCM be audited by an independent auditor. In addition, other regulations cover minimum financial requirements for FCMs and the computational formula used to determine net capital requirements and segregation requirements and funds in segregation.

314. Because a substantial number of FCMs are registered security brokers or dealers, the CFTC and SEC have acted to make each agency's minimum financial regulations and reporting requirements compatible, where possible. Therefore, a security broker or dealer may file with the CFTC unaudited quarterly data in the form required by the SEC. The audit filing with the CFTC for a security broker or dealer is also similar to that required by the SEC. However, the report cover, the attestation, and the non-public treatment of certain of the financial statements and supplementary schedules differ from those the SEC requires. The independent public accountant should refer to CFTC regulations 1.10-1.17 to assure compliance. The audited filing with the CFTC must also include an accountant's report on internal accounting control. This report (see exhibit K in the Financial Statement Exhibits section of this guide) is filed with the CFTC in lieu of the report on internal accounting control required by rule 17a-5 of the SEC. FCMs not regulated by the SEC are required to file with the CFTC

unaudited quarterly and audited annual financial statements and schedules in the form required by that agency.

Operations

315. The commodity department usually functions as an independent unit with its own purchase and sale, bookkeeping and margin departments. The commodity general ledger reflects all real and nominal accounts related to commodities. The broker's or dealer's general ledger usually includes a control account which represents the net balance in those commodity accounts.

316. Transactions in commodities involve futures and forward contracts or spot (cash) transactions. A futures contract is an agreement executed on a contract market to buy or sell a standard quantity of a specified commodity of a certain grade at a future delivery date at a specified price. Settlement generally is made by executing an offsetting futures contract either before or during the delivery month specified in the contract; this settlement is known as a round turn. A forward purchase or sale contract is an agreement (not executed on a contract market) to deliver or receive a specified quantity of a commodity at a specified price at a future date. A spot (cash) transaction involves delivery of the commodity. Customers of brokers or dealers generally are not interested in making or accepting delivery of a commodity; instead, they wish only to trade in the futures contracts.

317. Security brokers and dealers who also deal in commodities generally engage in several activities. The larger brokers or dealers may act in the capacity of FCMs, cash commission merchants, commodity merchandisers and country and terminal grain elevator operators. Since commodity trading is a highly specialized activity, relatively few brokers or dealers engage in all of these activities.

318. Trading in futures is the most common type of commodity transaction and, accordingly, is the kind which will be most frequently encountered in examinations of brokers or dealers. Cash (spot) trading occurs less frequently.

319. The underlying commodities for commodity futures contracts include the basic grains, soybeans, eggs, potatoes, sugar, coffee, and other foodstuffs; meats such as beef cattle and hogs; precious metals including gold, silver, and platinum; and cotton and foreign currencies. Contracts in financial instruments such as U.S. treasury bills and GNMA securities are also traded by those investors who wish to speculate or hedge in the "interest rate futures" market.

320. In the absence of a futures market for these commodities, food processors, millers, farmers, merchants and other producers and users who must contract for or carry large physical quantities of these commodities would be subject to the risk of loss due to price changes. The futures market, however, affords these users a means of price protection by enabling them to hedge the physical quantities in either their raw or finished state.

321. In its simplest form, hedging involves simultaneously purchasing the physical commodity to replenish inventory and buying a contract for the sale of the same commodity for delivery at some future date. Theoretically, a physical (spot) inventory is accumulated, and futures (sales) contracts are entered into to hedge against loss due to price fluctuations. As the physical inventory of the commodity is sold, the futures trade is closed by buying-in the previous sales contracts. Any loss incurred on the futures transaction becomes part of the cost of sales and will be offset by a profit on the inventory liquidation.

322. Through continued application of futures transactions, commodity users can avoid a large part of the potential losses caused by fluctuations in the market price of the commodity.

323. Although price protection is the basic purpose of a futures market, the speculator plays a major role in making an effective market. The speculator assumes the risk of price changes, and it is these changes in price that provide the speculator an opportunity for profit.

324. The CFTC regulates commodity exchanges and has the authority to promulgate rules and regulations for the industry. Some of the provisions of the regulations limit for each commodity the quantities of futures contracts that any one person may acquire, require daily reporting of trading activity by exchange members and restrict use of customers' funds deposited with brokers as margin on futures contracts.

325. In addition to federal government regulations, brokers or dealers must conform to the requirements of the various contract markets or exchanges and associated clearing organizations of which they are members. These self-regulatory organizations are similar in nature to security exchanges in that they maintain and provide a marketplace for buyers and sellers and establish standards for orderly trading. Initial and maintenance margin requirements have also been established for most commodities. Unlike security exchanges, however, commodity exchanges have set maximum daily price fluctuations for certain commodities.

326. The various exchanges have rules and regulations that require minimum initial margin deposits, depending on the commodity bought or sold. While the brokerage concern may establish its own requirements depending on the financial capability of a particular customer, they must not be less than the minimums set by the exchanges. Margin rates differ for each commodity and purpose for which a futures trade is made (that is, hedging or speculating). In periods of high volume of activity, when excessive speculation prevails, the exchanges often increase initial margin requirements. However, margin rates are subject to reduction or restoration to their previous level when conditions warrant a change.

327. In addition to initial margin requirements, maintenance margin requirements are commonly prescribed by the exchanges. Any impairment of the initial margin deposit due to price fluctuations below the maintenance margin level set by the exchange requires the customer to meet a margin call. In most cases the call must be sufficient to restore the margin to the maintenance level which is usually lower than the initial margin. For certain commodities the

call must be sufficient to restore the margin to the original margin deposit. If the call is not met within a specific period of time (hours or days), the customer's open futures position must be liquidated to the extent necessary to bring his account back to a status that conforms to the margin requirements.

328. Execution of orders for commodity futures trades by brokers or dealers is somewhat similar to the handling of stock or bond orders. However, a broker or dealer, other than one which places its commodity transaction through a correspondent broker, actually deals with a clearing organization when it buys and sells futures contracts for the account of its customers. According to commodity exchanges rules, the clearing organization acts as a substitute for the other broker that is a party to the transaction. As a result, offsetting transactions entered into by the same broker or dealer are immediately balanced against one another by the clearing organization.

329. Accounting for a commodity futures contract transaction differs from that of a security transaction. While a confirmation of the trade is submitted to the customer showing the pertinent price, quantity and commodity data, no monetary entry is made in the customer's ledger. The customer's account reflects only the margin deposit and the open contracts in the commodities traded and, in memorandum format, shows if the account liquidates to an equity or deficit.

330. At the close of business each day the commodity exchange usually establishes a settlement price to which all contracts are to be adjusted, that is, marked-to-the-market. Each day, all open contracts are listed, together with the quantity, contract price and settlement price. The net difference (gain or loss) is determined, after considering the nature of the individual variations, and settled in cash with the clearing organization. The broker or dealer records the amount of the daily settlements in contract difference accounts from which gains and losses are transferred to the customers' accounts when round turns have been completed.

331. The clearing organization establishes standing margins which are used as collateral to guarantee a broker's or dealer's commitments. The amount of margin is based on the position in each commodity depending on the requirement of the clearing organizations. The required collateral (cash, letters of credit or qualified securities) generally is deposited by the clearing organization in a bank account designated by the broker or dealer, and evidence of these deposits in the form of margin certificates is delivered by the bank to the clearing member.

332. All funds deposited by customers and all funds accruing to customers as a result of trades or contracts must be accounted for separately and deposited in separate bank accounts appropriately designated as segregated customers' funds or invested in "qualified securities" under the Commodity Exchange Act. Such investments are limited to obligations of the United States or general obligations fully guaranteed as to principal and interest by the United States and must be deposited in an escrow account with a bank. Income derived from these securities accrues to the broker or dealer. The amount of money and securities to be deposited in segregated accounts in order to comply with the requirements of the Commodity Exchange Act must be computed as of the close of the market each business day.

333. In determining customers' funds to be segregated, a deficit in the account of one customer cannot be offset against the equity of another customer. Separate accounts must be kept for customers trading in both regulated and nonregulated (foreign market) commodities because the Commodity Exchange Act prohibits commingling of funds and transferring between the various types of a customer's accounts except on specific written authorization of the customer. The independent auditor should determine that procedures are in effect to properly identify qualified securities as margin deposits to prevent these securities from being used for other purposes. The CFTC does not regulate margin requirements on futures trades; these are regulated by the various exchanges. However, the Commodity Exchange Act specifies that customers' funds deposited in accounts designated as regulated commodity accounts may be used only to margin customers' regulated commodity positions.

334. Brokers or dealers that are also futures commission merchants must file a Schedule of Segregation Requirements and Funds in Segregation for customers' regulated commodity futures accounts with part II of Form X-17A-5 to the SEC on a quarterly basis. The independent auditor must also file this schedule with the annual audited Form X-17A-5. (Exhibit H, schedule IV, in the Financial Statements Exhibits section of this guide, shows the schedule required to be filed with the SEC.)

335. Many brokers or dealers, particularly those located outside the exchange cities, do not deal directly with the commodity exchanges but place their commodity transactions through correspondent brokers or dealers. In those instances, the accounts of the broker or dealer may not contain a contract difference account since the offset to purchases and sales of commodity futures transactions will be in the account with the correspondent broker or dealer.

Examination of Commodity Accounts

336. In many respects, auditing procedures applicable to commodity accounts do not differ substantially from those relating to security accounts. The basic procedures of making a study and evaluation of internal accounting controls, confirming, balancing of positions, margining, inspecting documents and reviewing account classification should be carried out. In addition, the independent auditor should review the procedures for complying with CFTC segregation and net capital requirements and, as of the date of the financial statements, should recompute the calculation of such requirements and consider whether sufficient funds are appropriately segregated and net capital requirements are met.

337. The independent auditor conducting an examination of financial statements of a broker or dealer doing business in commodities should obtain a copy of the Commodity Exchange Act as amended by the Commodities Futures Trading Commission Act of 1974 and the related regulations as well as the regulations of the applicable contract markets and clearing organizations.

338. The auditor should have an understanding of the following areas which are unique to the commodity department.

Clearing Organizations for Settlement of Commodity Futures Contracts

339. A broker or dealer ordinarily will be a member of the clearing organization which is affiliated with any commodity exchange through which the broker or dealer executes transactions. The clearing organization prepares daily settlement reports (recapitulation sheets) based on the transactions executed by member brokers or dealers at a daily settlement price determined by the clearing organization. The net amount payable or receivable is settled by a check or draft forwarded with the daily reports. The daily reports also show the amount of original margin deposits controlled by the clearing organization as protection against defaults on contracts.

340. The positions open with the clearing organizations, the amounts receivable or payable on settlements and the aggregate amounts of original margin should be confirmed by submitting to each clearing organization a copy of the clearing sheet as of the date of the financial statements together with a request for certification of the details shown on it. The auditor should review subsequent clearing sheets for a selected number of days after the date of the financial statements for open trades as of the date of the financial statements which may have been cancelled thereafter on "out trades" as of the date of the financial statements which were cleared "as of" a later date.

Spot (Cash) Commodities in Physical Possession

341. Spot commodities ordinarily are represented by warehouse receipts or bills of lading, although some commodities such as gold, silver or platinum may be in the physical possession of the broker or dealer. The documentary evidences of ownership of such commodities may be in the possession of the broker or dealer, or they may have been deposited with a lender with whom evidences of ownership are pledged as collateral.

342. The independent auditor should consider examining warehouse receipts and bills of lading which are in the physical possession of the broker or dealer and should trace into the records any entries relating to such documents which may be in transit between offices of the broker or dealer at the date of the financial statements. Direct confirmation in writing should be obtained from the warehouses when the amounts involved are material and from lenders as to any documents that may have been pledged as collateral for loans. The auditor should be aware of the guidance provided by SAS no. 1, section 901, for commodities held by public warehouses.

343. The auditor should observe the counting or weighing of commodities in the physical possession, and he should take whatever steps are necessary in the circumstances to satisfy himself concerning the types and grades of commodities.

Accounts Carried by Other Brokers and Dealers in Commodities

344. If a broker or dealer trades in commodities for which transactions are executed on a commodity exchange of which the broker or dealer is not a

member, it probably maintains open accounts with other brokers or dealers who are members of that exchange. Those accounts are usually referred to as carrying or correspondent brokers' accounts and as of a given date, like other commodities' accounts, show a debit or credit money balance and commodity positions either long or short.

345. The auditor should request from brokers or dealers with which such accounts are maintained a statement of the account as of the date of the financial statements showing the cash balance and the commodity positions long or short. These statements should be compared with the records of the broker or dealer under audit. To facilitate reconciling the account, the auditor may mail a statement of the account to the carrying broker, requesting confirmation of the balance and position.

Customers' Commodity Accounts[7]

346. Customers' commodity accounts fall into two general classes: accounts with spot (cash) commodities' positions and those with open future contracts.

347. Written requests for confirmation of the balances and positions in accounts should be mailed directly to customers in a manner similar to that followed for customers' securities accounts.

Accrued Commodity Commission Receivable and Payable

348. Accrued commodity commissions receivable and payable represent commissions due from customers or due to other brokers on half-turn transactions (open long and short positions). These amounts can be tested by reference to the broker's or dealer's commission schedule. Since the broker or dealer has performed all of the required services and incurred the costs of earning one-half of the round turn commissions on open commodity positions, such commissions, if material, should be accrued, even though they are not billed to customers until the position is closed.

Commodity Daily Settlement Accounts

349. The daily settlement account balances represent checks payable to, or drafts receivable from, various clearing organizations due to "variation margin." (The variation margin is the last day point fluctuation, that is, the difference between the prior day's settling price or contract prices during the day and last day's settling price, on net long or short positions. The balance may be net or gross, depending on clearing organization requirements.) This account should be analyzed, the net balance broadened to reflect drafts receivable and payable, and the amounts agreed to certified copies of clearing sheets after consideration of the effects of "out trades."

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[7] See chapter 4 for a discussion of the timing of audit procedures.

Commodity Exchange Fees

350. Commodity exchange fees are fees due from the exchange members' customers on uncompleted round turns (open long and short positions) and due to various clearing organizations on execution of trades thereon. This account should be analyzed; the net balance should be broadened into fees receivable and payable and reconciled to copies of statements filed with clearing organizations; and subsequent payments should be traced to the cash journal.

Commodity Brokerage Payable

351. The commodity brokerage payable account represents brokerage fees due to other brokers for trades executed by them on the floor of the exchange for the account of the broker or dealer under examination. Appropriate audit procedures for these payables include confirmation or comparison of the bills for the current month with payments subsequent to the current month to determine the accrual.

Balancing Commodity Futures Positions

352. Commodity positions are balanced in the same way as security positions. Positions in the accounts of customers, partners, trading accounts of the broker or dealer, and other brokers' positions long and short are recorded from certified copies of the clearing sheets, and from statements from correspondent brokers. Frequently a schedule is prepared in commodity sequence, which includes each commodity futures contract by month of contract maturity together with extended contract values and market values and resultant gain or loss. This schedule is called a "point balance schedule." The gains and losses shown should be in agreement with the contract difference accounts. In addition, the customer's commodity positions liquidated to equity or deficit should agree to the total of the point balance schedule.

Valuation of Commodity Futures Contracts

353. Commodity contracts should be extended at both contract and market value (settling price at date of the financial statement as per certified copies of recapitulation sheets), and the resulting gains or losses should be computed. If the broker or dealer deals directly with the clearing organization, the amount shown in the contract difference account, which represents cumulative daily clearing organization settlements, should balance the net gains or losses determined for offsetting contracts of customers and others. Since this operation automatically proves the balances in the contract difference accounts in the general ledger, it will eliminate the necessity for test-checking extensions of contract and market values.

Margining of Customers' Commodity Accounts

354. Because of the volatility of the futures market and the significant amounts involved, the independent auditor should be particularly concerned with

the procedures and controls related to the extension of credit to customers, including trading limits, daily monitoring of accounts, and prompt follow-up of margin calls.

355. As with security accounts of customers, margining of customers' commodity accounts is not required for purposes of completing the financial statements required by rule 17a-5 of the SEC. However, it is necessary to review the margining of customers' commodity accounts for purposes of computing capital requirements under rule 15c3-1 and CFTC or commodity exchange requirements, as well as for determining collectibility exposure.

356. Computing margins in customers' commodity accounts is performed in much the same way as computing margins in customers' security accounts. That is, the equity in the account is tested with the margin required by the commodity exchanges for the various types of commodities carried in the account.

357. Before testing the margining of commodity accounts the independent auditor should obtain the following:

- The "house rule" margin requirements of the broker or dealer and the latest margin notice issued by the applicable contract market.
- List of outstanding margin calls.
- List of trade accounts, including accounts with credit lines granted.
- List of proprietary accounts.

358. Customers' accounts with margin deficiencies should be reviewed for subsequent transactions to consider whether outstanding margin calls, if any, have been satisfied.

PREFACE TO FINANCIAL STATEMENT EXHIBITS

The financial statements required to be filed under FOCUS and the requirements of most regulatory agencies are not required to be in comparative form, and the accompanying financial statement exhibits are not prepared on that basis. However, it is preferable that the financial statements of brokers or dealers be presented on a comparative basis. With comparative financial statements, there is no need to present the supplementary information on a comparative basis.

The accompanying financial statements are illustrative only and have been prepared to show how various items might be presented, assuming they are material in the particular circumstances. In the usual situation, several items may not be included while some of those that are included might well be combined and presented as a single item.

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ANNUAL AUDITED REPORT FORM X-17A-5 PART III

FACING PAGE

Information Required of Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder

SEC FILE NO.
8-

REPORT FOR THE PERIOD BEGINNING ____________ AND ENDING ____________
MM / DD / YY — MM / DD / YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER:

Standard Stockbrokerage Co., Inc.

Official Use Only
FIRM ID. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS:
(Do not use P.O. Box No.)

1 Main Street
(No and Street)

New York	New York	10004
(City)	(State)	(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Joseph P. Brokestock — (212) 490-1200
(Area Code — Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report*
(Name - - if individual, state last, first, middle name)

Accounting Firm

2 Main Street	New York	New York	10004
(ADDRESS) Number and Street	City	State	Zip Code

CHECK ONE:

- [X] Certified Public Accountant
- [ ] Public Accountant
- [ ] Accountant not resident in United States or any of its possessions.

FOR OFFICIAL USE ONLY

* *Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption.*
See section 240.17a-5(e)(2).

OATH OR AFFIRMATION 1/

I, Joseph P. Brokestock, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Standard Stockbrokerage Co., as of December 31, 19X1, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

Security accounts of principal officers and directors which are classified as customer accounts (debits $316,513, credits $273,412)

____
Signature

Subscribed and sworn to before me this ____ day of _____ 19x2

Vice-President - Finance
Title

Joseph P. Notary
Notary Public

This report * contains (check all applicable boxes):

- [X] (a) Facing page
- [X] (b) Statement of Financial Condition
- [X] (c) Statement of Income (loss)
- [X] (d) Statement of Changes in Financial Condition
- [X] (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's Capital.
- [X] (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
- [X] (g) Computation of Net Capital Pursuant to Rule 15c3-1.
- [X] (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
- [X] (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
- [X] (j) A Reconciliation, including appropriate explanation, of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
- [ ] (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
- [X] (l) An Oath or Affirmation
- [ ] (m) A copy of the SIPC Supplemental Report
- [ ] (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.
- [X] (o) Independent auditor's report on internal accounting control.
- [X] (p) Schedule of Segregation Requirements and Funds in Segregation - Customers' Regulated Commodity Futures Accounts Pursuant to Rule 17a-5.

* *For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).*

1/ Various exchanges may require a different form of oath or affirmation.

EXHIBIT A

Independent Auditor's Report on Examination of Corporate Financial Statements

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have examined the consolidated statement of financial condition of Standard Stockbrokerage Co., Inc., and Subsidiaries as of December 31, 19X1, and the related consolidated statements of income, stockholders' equity, changes in liabilities subordinated to claims of general creditors, and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

*In our opinion, the financial statements referred to above present fairly the consolidated financial position of Standard Stockbrokerage Co., Inc., and Subsidiaries as of December 31, 19X1, and the results of their operations and changes in their financial position for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

**Our examination was made for the purpose of forming an opinion on the basic financial statements, taken as a whole. The information contained in schedules I, II, III and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the examination of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole, and in conformity with the rules of the Securities and Exchange Commission.

Accounting Firm

New York, New York
February 15, 19X2

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*See note on page 88.

**See note on page 89.

NOTES TO EXHIBIT A:

*If securities and investments that are not readily marketable are material, it will be necessary to review the procedures and underlying documentation supporting the valuations. If the auditor concludes that the valuation procedures are inadequate or unreasonable or the underlying documentation does not support the valuation, he may need to issue a modified opinion because of a departure from generally accepted accounting principles. Presented below is an example of a qualified opinion (assuming the auditor cannot reasonably determine the effects of the departure).

Middle Paragraph:

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to $10,730,685 (8.5% of total assets) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation, and believe that the procedures are not reasonable and the documentation is not appropriate to determine fair value of the securities. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

Opinion Paragraph:

In our opinion, except for the effects on the financial statements of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements referred to above present fairly the consolidated financial position. . . .

[In certain circumstances, depending on materiality, the qualification could relate only to the income statement.]

The auditor might conclude, based on his review of management valuation procedures and the underlying documentation, that in the circumstances the procedures appear to be reasonable and the documentation appropriate, but that the determination of fair value involves subjective judgment that is not susceptible to substantiation by auditing procedures. In such cases, the auditor may need to modify his opinion because of a scope limitation. Presented below is an example of an opinion qualified because of a scope limitation.

Middle Paragraph:

As discussed in Note 1 to the financial statements, investment securities not readily marketable amounting to $10,730,685 (8.5% of total assets) as of December 31, 19X1, have been valued at fair value as determined by the Board of Directors. We have reviewed the procedures applied by the directors in valuing such securities and investments and have inspected underlying documentation; while in the circumstances the procedures appear to be reasonable and the documentation appropriate, determination of fair value involves subjective judgment which is not susceptible to substantiation by auditing procedures.

Opinion Paragraph:

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, been susceptible to substantiation by auditing procedures, the financial statements referred to above present fairly the consolidated financial position. . . .

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*It is also acceptable to present a separate auditor's report on the supplementary schedules as follows:

Supplementary Information Required by
SEC Rule 17A-5

The information contained in Schedules I, II, III and IV on the following pages is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 of the Securities and Exchange Commission. Such information has been subjected to the auditing procedures applied in the examination of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements, taken as a whole, and in conformity with the rules of the Securities and Exchange Commission.

Accounting Firm

EXHIBIT B

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Consolidated Statement of Financial Condition
December 31, 19X1

ASSETS

Cash	$ 2,647,472
Cash and securities segregated under federal and other regulations (Note 3)	1,005,000
Deposits with clearing organizations and others (Cash $345,000 and securities with a market value of $1,400,000)	1,745,000
Receivable from brokers and dealers (Note 4)*	25,476,250
Receivable from customers (Note 5)*	40,360,723
Securities purchased under agreements to resell	6,282,498
Securities owned (Note 6):	
Marketable, at market value	20,738,387
Not readily marketable, at estimated fair value	10,730,685
Spot commodities owned (sold for future deliveries), at market value	3,278,000
Secured demand notes collateralized by marketable securities	5,215,000
Memberships in exchanges:	
Owned, at cost less $825,000 valuation allowance (market value $2,000,000)	2,100,000
Contributed for the use of the Company, at market value	375,000
Furniture, equipment and leasehold improvements, at cost, less accumulated depreciation and amortization of $2,425,249 (Note 10)	4,881,769
Other assets	723,459
	$125,559,243

LIABILITIES AND STOCKHOLDERS' EQUITY

Short-term bank loans (Note 7)	$ 23,000,000
Drafts payable	3,902,000
Payable to brokers and dealers (Note 4)	12,015,622
Payable to clearing broker (Note 8)	9,359,621
Payable to customers (Note 5)	12,288,629
Securities sold under agreements to repurchase (Note 9)	5,780,498
Securities sold, but not yet purchased, at market value	1,862,729
Income taxes, including deferred taxes of $1,200,000	2,276,473
Accounts payable, accrued expenses, and other liabilities	2,074,499
Long-term notes payable (Note 10)	3,000,000
	75,560,071
Commitments and contingent liabilities (Note 14)	
Liabilities subordinated to claims of general creditors (Note 11)	10,272,000
Stockholders' equity (Notes 12 and 15)**	
Preferred stock	5,000,000
Common stock	6,289,000
Additional paid-in capital	2,200,000
Retained earnings	27,438,172
Less common stock in treasury, at cost	(1,200,000)
Total stockholders' equity***	39,727,172
	$125,559,243

The accompanying notes are an integral part of this financial statement.

*See notes on page 92.

NOTES TO EXHIBIT B:

*Valuation reserves should be shown parenthetically or in a note if material.

**Although liabilities subordinated to general creditors may be part of the regulatory capital base, it is not permissible to present a combination of subordinated liabilities and stockholders' equity.

***It is permissible, for the purpose of the separate report on the statement of financial condition (which is required to be distributed to customers), to present only the total of stockholders' equity without disclosure of the various components.

EXHIBIT C

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Consolidated Statement of Income

Year Ended December 31, 19X1

Revenues	
Commissions	$ 40,980,211
Net dealer inventory and investment gains (losses)*	1,606,778
Investment banking	1,789,000
Interest and dividends	1,242,823
Other	400,000
	46,018,812
Expenses	
Employee compensation and benefits	10,289,128
Commissions and floor brokerage	9,128,491
Communications	6,826,000
Occupancy and equipment rental	1,625,000
Interest	896,482
Taxes, other than income taxes	127,777
Other operating expenses	3,421,001
	32,313,879
Income before income taxes	13,704,933
Income taxes, including deferred taxes of $425,000 (Note 16)	7,100,000
Net income	$ 6,604,933
Earnings per share of common stock (Note 17)	$4.88**

The accompanying notes are an
integral part of this financial statement.

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*The amount of the change in unrealized gains and losses attributable to investment securities which are not readily marketable and which have been valued at fair value by management should be disclosed, if material.

**Not required to be presented by non-public enterprises defined by the FASB Statement No. 21, Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises.

EXHIBIT D

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Consolidated Statement of Changes in Financial Position

For the Year Ended December 31, 19X1

Funds provided by	
Operations	
Net income	$ 6,604,933
Items not affecting funds	
Depreciation and amortization	582,371
Write down of exchange memberships	400,000
Deferred income taxes	425,000
Total from operations	8,012,304
Increase in	
Payable to clearing broker	2,427,541
Securities sold under agreements to repurchase	587,313
Liabilities subordinated to claims of general creditors	5,688,000
Decrease in	
Net receivable from brokers and dealers	2,314,316
Securities purchased under agreements to resell	2,348,518
Securities owned, net	4,655,123
Cash and deposits with clearing organizations and others	1,220,742
Common stock issued from treasury	78,000
	$27,331,857
Funds applied to	
Increase in	
Net receivable from customers	$10,801,317
Spot commodities owned	2,314,128
Secured demand notes receivable	3,325,000
Decrease in	
Short-term bank loans	7,662,496
Drafts payable	1,329,652
Payments of long-term notes payable	500,000
Retirement of preferred stock	262,500
Purchase of common stock for treasury	180,000
Dividend on preferred stock	250,000
Other, net	706,764
	$27,331,857

The accompanying notes are an
integral part of this financial statement.

EXHIBIT E

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Consolidated Statement of Changes in Stockholders' Equity

For the Year Ended December 31, 19X1

	Capital Stock		Additional Paid-in	Retained	Treasury
	Preferred	Common	Capital	Earnings	Stock
Balances at January 1, 19X0	$5,250,000	$6,289,000	$2,212,500	$21,083,239	($1,098,000)
Net income				6,604,933	
Retirement of 2,500 preferred shares	(250,000)		(12,500)		
Dividend on preferred stock, $5 a share				(250,000)	
Repurchase of 6,000 common shares for treasury					(180,000)
Sale of 2,600 common shares from treasury upon exercise of options					78,000
Balances at December 31, 19X1	$5,000,000	$6,289,000	$2,200,000	$27,438,172	($1,200,000)

The accompanying notes are an integral part of this financial statement.

EXHIBIT F

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Consolidated Statement of Changes in Liabilities
Subordinated to Claims of General Creditors
For the Year Ended December 31, 19X1

Subordinated liabilities at beginning of year	$ 4,604,000
Increases	
Liability pursuant to secured demand note collateral agreements	3,325,000
Issuance of subordinated notes	5,675,000
Decreases	
Payment of subordinated notes	(3,307,000)
Decrease in market value of exchange memberships contributed for the use of the Company	(25,000)
Subordinated liabilities at end of year	$10,272,000

The accompanying notes are an
integral part of this financial statement.

EXHIBIT G

STANDARD STOCKBROKERAGE CO., INC.
AND SUBSIDIARIES

Notes to Consolidated Financial Statements

For the Year Ended December 31, 19X1

(Note: The following notes to financial statements are illustrative only. In some situations, the information in notes may be better presented within the financial statements; in other situations, information not required by regulation may not be sufficiently material to warrant disclosure.

In addition to the disclosures shown, there may be certain additional disclosures required under regulation S-X of the Securities and Exchange Commission for those companies that are registered under section 12 (b) or 12 (g) of the Securities Exchange Act of 1934. Regulation S-X does not apply to the financial statements filed with the SEC under rule 17a-5.)

1. Significant accounting policies

The consolidated financial statements include the accounts of the Company, all wholly-owned subsidiaries, and a subsidiary which is 80% owned. Such subsidiaries are engaged primarily in brokerage, investment advisory, and venture capital business. All material intercompany balances and transactions are eliminated in consolidation.

Securities transactions are recorded on a settlement date basis.* Commission income and expenses are reflected in these financial statements as of the trade date. Commission revenue and related expenses on commodities futures transactions are recorded on the trade date. Income or loss on transactions in Government National Mortgage Association and other money market instruments and related expenses are reflected in operations on the trade date. Investment banking revenue is recorded as follows:** management fees on offering date, sales concessions on settlement date, and underwriting fees at the time the underwriting is completed and the income is reasonably determinable.

Marketable securities are valued at market value and securities not readily marketable are valued at fair value as determined by the board of directors. The resulting difference between cost and market (or fair value) is included in income.

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*See further discussion in Chapter 1 of this guide regarding settlement date versus trade date basis accounting.

**Illustrative disclosure, not necessarily required.

Open commodity future and forward transactions are carried at current market value. At December 31, 19X1, the Company had open purchases and sales of such contracts in the amount of $1,200,000 and $4,250,000, respectively.

Repurchase and resale agreements are treated as financing transactions and are carried at the amounts at which the securities will be subsequently reacquired or resold as specified in the respective agreements.

Deferred income taxes are provided when income and expenses, principally relating to the valuation of trading and investment securities, are recognized in different years for financial and tax reporting purposes. Investment tax credits are accounted for on the "flow-through" method, under which the benefit is reflected as a reduction of the tax provision in the year related assets are placed in service.

Depreciation is provided on a straight-line basis using estimated useful lives of ten to fifteen years. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

Exchange memberships are carried at cost less an allowance of $825,000 which represents management's estimate of the permanent impairment of value of certain memberships.

2. Consolidated subsidiaries*

The following is a summary of certain financial information of the company's consolidated subsidiaries:

	Broker/ Dealer (100% owned)	Investment Advisory (100% owned)	Venture Capital (80% owned)	Total
		(Amounts in Thousands)		
Total assets	$12,700	$1,700	$5,100	$19,500
Stockholders' equity	2,800	400	1,800	5,000

*Information in this note is presented principally to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of "flow through" capital of broker/dealer subsidiary). If the company and its subsidiaries are engaged in unrelated business which could be considered separate business segments, it may be necessary for public companies to disclose financial information of the separate business segments as required by FASB Statement No. 14.

The $2,800,000 of stockholders' equity and $1,500,000 of subordinated liabilities of the broker-dealer subsidiary are included as capital in a consolidated computation of the company's net capital since the assets of the subsidiary are readily available for the protection of the company's customers, broker-dealers and other creditors, as permitted by Rule 15c3-1. The accounts of the other subsidiaries are not included in the computation.

3. Cash and securities segregated under federal and other regulations

Cash of $375,000 and United States Treasury bills with a market value of $630,000 are segregated under the Commodities Exchange Act, and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Cash of $X,000,000 has been segregated in a special reserve bank account for the benefit of customers under rule 15c3-3 of the Securities and Exchange Commission.*

4. Receivable from and payable to brokers and dealers

Amounts receivable from and payable to brokers and dealers other than correspondents at December 31, 19X1, included:**

Securities failed-to-deliver	$18,213,250
Deposits on securities borrowed	1,420,000
Amounts due from brokers and dealers through clearing associations	5,212,000
Other	631,000
Total receivable	$25,476,250
Securities failed-to-receive	$ 4,674,379
Deposits received for securities loaned	2,175,000
Amounts due to brokers and dealers through clearing organizations	4,734,000
Other	432,243
Total payable	$12,015,622

*Possible wording in those situations where a deposit is required based on rule 15c3-3 computation.

**For purposes of the basic financial statements, it is generally not necessary to present the details of the receivables from and payables to brokers and dealers.

Fails-to-deliver and -to-receive represent the contract value of securities that have not been delivered or received subsequent to settlement date.

5. Receivable from customers

Accounts receivable from customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for those receivables.

6. Securities owned and sold but not yet purchased

Marketable securities owned and sold but not yet purchased consist of trading and investment securities at quoted market values. Marketable securities owned and sold but not yet purchased consist of the following.

	Owned	Sold But Not Yet Purchased
Obligations of U.S. government	$ 400,000	
State and municipal obligations	608,060	
Corporate bonds, debentures, and notes	6,900,000	
Corporate stocks	11,930,327	$1,190,415
Options and warrants	900,000	672,314
	$20,738,387	$1,862,729

Securities not readily marketable include investment securities (a) for which there is no market on a securities exchange or no independent publicly quoted market, (b) which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933, and (c) which cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the company.*

7. Bank loans

Short-term bank loans bear interest at a fluctuating rate based on prime (average rate of 9.1 percent at December 31, 19X1). The loans are fully collateralized by marketable securities valued at $26,000,000. Such collateral includes $16,500,000 of customers' margin account securities, $6,500,000 of securities owned by the company, and $3,000,000 of securities held pursuant to secured demand note collateral agreements.

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*In certain circumstances it may be desirable for certain brokers or dealers to show matched repurchase transactions separately.

8. Payable to clearing broker

The payable to clearing broker is for customers' transactions and is collateralized by customers' securities. Interest is at a fluctuating rate (9 percent at December 31, 19X1) which generally corresponds to the broker call money rate.

9. Securities sold under agreements to repurchase

At December 31, 19X1, the market value of the securities sold subject to repurchase was $5,790,000 and the average effective interest rate at that date on the transactions was 8.5 percent.

10. Long-term notes payable

The notes payable bear interest at 7.5 percent and are payable in semiannual installments of $250,000 through July 1, 19X7. Furniture and equipment with a net carrying value of $2,500,000 has been pledged to secure the notes.

11. Liabilities subordinated to claims of general creditors

The subordinated liabilities at December 31, 19X1 consist of:

Borrowings under subordination agreements:	
Subordinated notes, 10%, due December 31, 19X3	$ 4,682,000
Market value of exchange memberships contributed for the use of the Company, interest at 6% to 7%, due January 19X4	375,000
Liabilities pursuant to secured demand note collateral agreements, 6% due $1,000,000 in March 19X2, $1,200,000 in March 19X3, and $3,015,000 in December 19X3	5,215,000
	$10,272,000

The subordinated borrowings are covered by an agreement approved by the New York Stock Exchange (or other regulatory organizations) and are thus available, except for the exchange membership, in computing net capital under the Securities and Exchange Commission's uniform net capital rule. To the extent that such borrowings are required for the company's continued compliance with minimum net capital requirements, they may not be paid (Note 15).*

*Significant restrictive covenants of debt agreements should be disclosed.

12. Capital stock

Preferred stock, $5 cumulative, $100 par value, redeemable at $105 a share; authorized 100,000 shares; issued and outstanding 50,000 shares	$ 5,000,000
Common stock, without par value; authorized 2,500,000 shares; issued 1,500,000 shares (in treasury 199,100 shares)	$ 6,289,000

In 19X1 stockholders approved adoption of a qualified stock option plan covering 100,000 shares of common stock. Options may be granted during the period to June 19X7 at 100 percent of the market value at the date of grant and are exercisable within five years from date of grant. During 19X1, options for 40,000 shares were granted at $30 a share and options for 2,600 shares were exercised.

13. Pension plans

The company and its subsidiaries have several pension plans covering substantially all of their employees. The total pension expense for 19X1 was $125,000, which includes, as to certain defined benefit plans, amortization of past service costs over periods ranging from twenty-five to forty years. The Company makes annual contributions to the plans equal to the amounts accrued for pension expense. The accumulated plan benefits and plan net assets as of December 31, 19X1, are as follows:

Actuarial present value of accumulated plan benefits:	
Vested	$1,625,000
Nonvested	75,000
	$1,700,000
Net assets available for benefits	$1,704,000

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 7%.

14. Commitments and contingent liabilities

Under operating leases with remaining non-cancellable terms in excess of one year at December 31, 19X1, aggregate annual rentals for office space and equipment are approximately as follows:

19X2	$1,492,000
19X3	1,440,000
19X4	1,006,000
19X5	982,000
19X6	901,000
Later years	1,164,000
	$6,985,000

Certain of these leases have escalation clauses and renewal options. Rental expense charged to operations for 19X1 was $985,000 for office space and $425,000 for data processing and other equipment.

The company and a subsidiary, together with various other brokers or dealers, corporations and individuals, have been named as defendants in several class action lawsuits which allege violations of federal and state securities laws and claim substantial damages. The company is also a defendant in other lawsuits incidental to its securities and commodities business. Management of the company, after consultation with outside legal counsel, believes that the resolution of these various lawsuits will not result in any material adverse effect on the company's consolidated financial position.

In the normal course of business, the company enters into underwriting commitments. Transactions relating to such underwriting commitments which were open at December 31, 19X1, and were subsequently settled had no material effect on the financial statements as of that date.

The company also engages in purchase, sale, and future contract transactions involving GNMA securities. At December 31, 19X1, unsettled purchase and sale commitments amounted to approximately $870 million and $925 million, respectively. In addition, the company had options to sell $242 million of GNMA securities and sold options under which the company may be required to purchase $175 million of such securities.

The company was contingently liable as of December 31, 19X1, in the amount of $4,375,000 under bank guarantees and letter of credit agreements used in lieu of margin deposits. These agreements are generally made for periods of six months to one year and bear interest at rates from .5 percent to 1 percent.

15. Net capital requirements

The company is subject to the Securities and Exchange Commission uniform net capital rule (rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1 (and the rule of the "applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1*). At December 31, 19X1, the company had net capital of $23,784,221, which was $20,009,112 in excess of its required net capital of $3,775,109. The company's net capital ratio was 2.4 to 1.**

16. Income taxes

The income tax provision consists of the following.

Federal	$5,300,000
State and local	1,800,000
	$7,100,000

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*Various regulatory agencies and exchanges may impose additional capital requirements which it may be necessary to disclose.

**If the company has elected to compute net capital under the alternative method of rule 15c3-1, appropriate wording would be as follows:

> The company is subject to the Securities and Exchange Commission's uniform net capital rule (rule 15c3-1), which requires the maintenance of minimum net capital. The company has elected to use the alternative method, permitted by the rule, which requires that the company and its subsidiary maintain minimum net capital, as defined, equal to the greater of $100,000 each or 2 percent of aggregate debit balances arising from customer transactions, as defined. (The net capital rule of the "applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if resulting net capital would be less than 5 percent of aggregate debits.) At December 31, 19X1, the company had net capital of $25,125,221, which was 46.6 percent of aggregate debit balances and $23,885,645 in excess of required net capital.

Deferred income taxes are principally applicable to unrealized appreciation of securities.

A reconciliation of the federal income tax ordinary rate of 46 percent with the actual effective rate provided is as follows.*

Ordinary federal income tax rate	46.0%
Increases (reductions) resulting from	
Tax exempt interest	(1.5)
Dividend deduction	(1.9)
State and local income taxes, net of federal tax benefit	7.1
Investment tax credits in the amount of $383,500	(2.8)
Other	4.9
Income tax rate incurred	51.8%

17. Earnings per share

Earnings per share of common stock was computed by dividing net income, less the preferred stock dividend requirement, by the weighted average number of common shares outstanding for the year (1,302,000 shares). Outstanding stock options were not dilutive.

*Generally optional disclosure for firms not subject to regulation S-X of the Securities and Exchange Commission. An explanation of a disproportionate tax provision, however, is required under generally accepted accounting principles.

EXHIBIT H

Supplementary Information

Pursuant to Rule 17a-5 of the
Securities Exchange Act of 1934

December 31, 19X1

(Note: The accompanying schedules are prepared in accordance with the requirements and general format of FOCUS Form X-17a-5. If desired, the preprinted FOCUS forms may be used for presenting the required supplementary information.)

Schedule I

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

NET CAPITAL		
Total consolidated stockholders' equity		$39,727,172
Deduct, stockholders' equity not allowable for net capital		2,200,000
Total stockholders' equity qualified for net capital		37,527,172
Add:		
A. Liabilities subordinated to claims of general creditors allowable in computation of net capital		9,897,000
B. Other (deductions) or allowable credits--deferred income taxes payable		1,200,000
Total capital and allowable subordinated liabilities		48,624,172
Deductions and/or charges		
A. Non-allowable assets		
Securities not readily marketable	$10,730,685	
Exchange memberships	2,100,000	
Furniture, equipment, and leasehold improvements	2,381,769	
Other assets	472,381	
	$15,684,835	
1. Additional charges for customers' and non-customers' security accounts	820,634	
2. Additional charges for customers' and non-customers' commodity accounts	78,450	
B. Aged fails-to-deliver		
1. Number of items--52	42,367	
C. Aged short security differences		
1. Number of items--6	44,870	
D. Secured demand note deficiency	525,000	
E. Commodity futures contracts and spot commodities--proprietary capital charges	163,900	
F. Other deductions and/or charges	522,610	(17,882,666)
Net capital before haircuts on securities positions		30,741,506

Schedule I (continued)

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

NET CAPITAL (cont'd)		
Net capital before haircuts on securities positions		$30,741,506
Haircuts on securities (computed, where applicable, pursuant to rule 15c3-1(f))		
A. Contractual securities commitments	$ 2,520,000	
B. Deficit in securities collateralizing secured demand notes	828,000	
C. Trading and investment securities		
1. Bankers' acceptances, certificates of deposit, and commercial paper	34,800	
2. U.S. and Canadian government obligations	27,300	
3. State and municipal government obligations	14,200	
4. Corporate obligations	184,000	
5. Stocks and warrants	2,682,000	
6. Options	212,000	
7. Arbitrage	-	
8. Other securities	53,400	
D. Undue concentrations	87,315	
E. Other	314,270	6,957,285
Net Capital		$23,784,221
AGGREGATE INDEBTEDNESS		
Included in consolidated statement of financial condition*		
Short-term bank loans (secured by customers' securities)		$14,500,000
Drafts payable		3,902,000
Payable to brokers and dealers		8,101,412
Payable to clearing broker		9,359,621
Payable to customers		11,716,031
Accounts payable and accrued expenses or liabilities includible in aggregate indebtedness		3,150,972
Total--forward		$50,730,036

*Excludes balances of consolidated subsidiaries other than wholly owned broker-dealer subsidiaries included in consolidated computation of net capital.

Schedule I (continued)

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

AGGREGATE INDEBTEDNESS (cont'd)	
Items included in consolidated statement of financial condition	$50,730,036
Items not included in consolidated statement of financial condition:	
Market value of securities borrowed for which no equivalent value is paid or credited	4,742,000
Other unrecorded amounts	1,154,598
	$56,626,634
Less adjustment based on special reserve bank accounts	-
Total aggregate indebtedness	$56,626,634
COMPUTATION OF BASIC NET CAPITAL REQUIREMENT	
Minimum net capital required	
Company	$ 3,346,836
Broker-dealer subsidiary	428,273
Total	$ 3,775,109
Excess net capital at 1500%	$20,009,112
Excess net capital at 1000%	$18,121,558
Ratio: Aggregate indebtedness to net capital	2.38 to 1
RECONCILIATION WITH COMPANY'S COMPUTATION* (included in Part II of Form X-17a-5 as of December 31, 19X1)	
Net capital, as reported in Company's Part II FOCUS report	$24,153,197
Allowable assets erroneously reported as non-allowable	
Deposits	582,641
Accrued interest receivable	378,420
Difference due to offsetting various asset accounts against related liabilities	(2,518,490)
Net audit adjustments	873,253
Other items, net	315,200
Net capital per above	$23,784,221

*If there is no material difference from the Company's computation, a statement to that effect is required.

Schedule I (continued)

STANDARD STOCKBROKERAGE CO., INC.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission

As of December 31, 19X1

COMPUTATION OF ALTERNATE NET CAPITAL REQUIREMENT*	
2% of aggregate debit items (or $100,000 if greater) as shown in formula for reserve requirements pursuant to rule 15c3-3 prepared as of date of net capital computation--Company	$ 1,077,235
Capital requirement of consolidated broker-dealer subsidiary electing alternative method	162,341
Total net capital requirement	$ 1,239,576
Excess net capital	$23,885,645**
Net capital in excess of	
5% of aggregate debit items	$22,026,281
6% of aggregate debit items	$21,406,496

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*To be included if Company has elected to use the alternate method of computing net capital pursuant to Appendix C of rule 15c3-1.

**Net capital under the alternative method is computed on a basis similar to the basic net capital computation but using generally lesser percentage security haircuts.

Schedule II

STANDARD STOCKBROKERAGE CO., INC.

Computation for Determination of Reserve Requirements
Under Rule 15c3-3
(Parent company only)

As of December 31, 19X1

CREDIT BALANCES:	
Free credit balances and other credit balances in customers' security accounts (including non-regulated commodity accounts, net of related margin deposits of $322,300)	$10,716,031
Monies borrowed collateralized by securities carried for the accounts of customers	18,402,000
Monies payable against customers' securities loaned	1,825,000
Customers' securities failed to receive (including credit balances in continuous net settlement accounts)	6,276,412
Credit balances in firm accounts which are attributable to principal sales to customers	1,238,376
Market value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days	327,841
Market value of short security count differences over 30 calendar days old	5,917
Market value of short securities and credits (not to be offset by "longs" or by debits) in all suspense accounts over 30 calendar days	78,118
Market value of securities which are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the 40 days	38,953
Total credit items	$38,908,648

Schedule II (continued)

STANDARD STOCKBROKERAGE CO., INC.

Computation for Determination of Reserve Requirements
Under Rule 15c3-3
(Parent company only)

As of December 31, 19X1

DEBIT BALANCES		
Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to rule 15c3-3		$37,322,458
Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver		1,318,216
Failed to deliver of customers' securities not older than 30 calendar days (including debit balances in continuous net settlement accounts)		14,782,362
Other		438,715
Total debit items		$53,861,751
RESERVE COMPUTATION*		
Excess of total debits over total credits		$14,953,103
Required deposit		None
RECONCILIATION with Company's computation** (included in Part II of Form X-17a-5 as of December 31, 19X1)		
Excess as reported in Company's Part II FOCUS report		15,492,744
Non-regulated commodity margin deposits erroneously excluded from the Company's report	322,300	
Other items, net	217,341	(539,641)
Excess per this computation		$14,953,103

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*Those firms calculating net capital under the alternative method are required to reduce this amount by 3 percent.

**If there is no material difference from the company's computation, a statement to that effect is required.

Schedule III

STANDARD STOCKBROKERAGE CO., INC.

Information Relating to Possession or Control Requirements
Under Rule 15c3-3
(Parent company only)

As of December 31, 19X1

1. Customers' fully paid securities and excess margin securities not in the respondent's possession or control as of the report date (for which instructions to reduce to possession or control had been issued as of the report date) but for which the required action was not taken by respondent within the time frames specified under rule 15c3-3.	$18,200*
A. Number of items	2*
2. Customers' fully paid securities and excess margin securities for which instructions to reduce to possession or control had not been issued as of the report date, excluding items arising from "temporary lags which result from normal business operations" as permitted under rule 15c3-3.	($39,000)**
A. Number of items	5

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*Subsequently was reduced to possession or control.

**In some instances it may be impractical to determine the number of items in response to item 2. Also, it may be impractical to determine whether the Company has subsequently issued instructions to reduce those items to possession or control or to determine that such instructions were acted upon.

Schedule IV

STANDARD STOCKBROKERAGE CO., INC.

Schedule of Segregation Requirements and Funds in Segregation for Customers' Regulated Commodity Futures Accounts

As of December 31, 19X1

SEGREGATION REQUIREMENTS

1. Net ledger balance	
a. Cash	$ 976,700
b. Securities (at market)	784,800
2. Net unrealized profit (loss) in open futures contracts	(354,000)
3. Net equity (Deficit) (Total of 1 - plus or minus 2)	$1,407,500
4. Add: accounts liquidating to a deficit and accounts with debit balances with no open trades	78,450
5. Amount required to be segregated (Total of 3 & 4)	1,485,950

FUNDS ON DEPOSIT IN SEGREGATION

6. Deposited in segregated funds bank accounts:	
a. Cash	204,200
b. Securities representing investments of customers' funds (at market)	140,300
c. Securities held for customers in lieu of cash margins (at market)	784,800
7. Margins on deposit with clearing organizations of contract markets:	
a. Cash	170,800
b. Securities representing investments of customers' funds (at market)	489,700
c. Securities held for customers in lieu of cash margins (at market)	—
8. Settlement due from (to) contract market clearing organization	(35,400)
9. Net equities with other FCMs	(37,200)
10. Segregated funds on hand:	
a. Cash	—
b. Securities representing investments of customers' funds (at market)	—
c. Securities held for customers in lieu of cash margins (at market)	—
11. Total amount in segregation (Total of 6 through 10)	1,717,200
12. Excess funds (Insufficiency) in segregation (11 minus 5)	$ 231,250

EXHIBIT I

Independent Auditor's Report on Internal Accounting Control Required by SEC Rule 17a-5

To the Board of Directors
Standard Stockbrokerage Co., Inc.

We have examined the financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. As part of our examination, we made a study and evaluation of the Company's system of internal accounting control (which includes the procedures for safeguarding securities) to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation, which included obtaining an understanding of the accounting system, was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the financial statements.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission, we have made a study of the practices and procedures[1]* followed by Standard Stockbrokerage Co., Inc., that we considered relevant to the objectives stated in Rule 17a-5(g), (i) in making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e); (ii) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by Rule 17a-13;[2] (iii) in complying with the requirements for prompt payment for securities of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System;[3] and (iv) in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.[4]

The management of the Company is responsible for establishing and maintaining a system of internal accounting control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. The objectives of a system and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

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*See notes on page 117.

Because of inherent limitations in any internal accounting control procedures or the practices and procedures referred to above, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the degree of compliance with them may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of Standard Stockbrokerage Co., Inc. taken as a whole. However, our study and evaluation disclosed no condition that we believed to be a material weakness.[5]

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Securities and Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives [except for the following conditions that we believe are material inadequacies in the practices and procedures comprehended in the Commission's objectives].[6]

This report is intended solely for the use of management and the Securities and Exchange Commission (specify any other regulatory body) and should not be used for any other purpose.[7]

Accounting Firm

New York, New York
February 15, 19X2

NOTES TO EXHIBIT I:

[1]If the broker or dealer is exempt from compliance with rule 15c3-3, certain references to this rule (item iv of the second paragraph) should be omitted. In addition, item (i) of the first paragraph should be revised as follows: "in making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the procedures for determining compliance with the exemptive provisions of rule 15c3-3." The independent auditor should include a statement indicating that the broker or dealer was in compliance with the conditions of the exemption, and that no facts came to the attention of the independent auditor indicating that such conditions had not been complied with during the period.

[2]If the broker or dealer does not maintain customer accounts and does not handle securities, he may not be required to, or have, any of the procedures described in items (ii), (iii), or (iv) of this paragraph. In this instance, it would be appropriate to indicate the procedures which have been reviewed and separately indicate those which have not been reviewed and the reason they were excluded. If the broker or dealer has occasional receipts of securities, even if such securities are immediately transmitted to a clearing organization or custodian, the report should retain the reference to the review of procedures for safeguarding securities since the broker or dealer is required to, and usually will, have such procedures. In some instances, a statement that the broker or dealer does not handle securities and accordingly has not established such procedures will be appropriate.

The following is an example of this paragraph of the report under these conditions.

> We also made a study of the practices and procedures followed by the company in making the periodic computations of aggregate indebtedness and net capital under rule 17a3(a)(11) and the procedures for determining compliance with the exemptive provisions of rule 15c3-3. We did not review the practices and procedures followed by the company (i) in making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by rule 17a-13 or (ii) in complying with the requirements for prompt payment for securities of Section 4(c) of regulation T of the Board of Governors of the Federal Reserve System, because the company does not carry security accounts for customers or perform custodial functions relating to customer securities.

[3]See Note 2.

[4]See Note 2.

[5]If the study and evaluation disclose material weaknesses, the report should describe the weaknesses that have come to the auditor's attention and state that they were considered in determining the audit tests to be applied in

the examination of financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

> "However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of Standard Stockbrokerage Co., Inc., may occur and not be detected within a timely period. (A description of the material weaknesses that have come to the auditor's attention and corrective action (see paragraph 186) would follow.) These conditions were considered in determining the nature, timing and extent of the audit tests to be applied in our examination of the 19X1 financial statements and this report does not affect our report on these financial statements dated (date of report)."

[6]Whenever inadequacies are described, the report should include the last sentence quoted in Note 5.

[7]A footnote to paragraph 48 of SAS no. 30 states that "this form of reporting is appropriate even though by law or regulation the accountant's report may be made a matter of public record."

Independent Auditor's Report on Internal Accounting Control Required by SEC Rule 17a-5

(Appropriate when the broker or dealer has not made the required notification or when the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.)

December 10, 19X2

Securities and Exchange Commission
(Washington) and Appropriate
Regional Office
Designated Examining Authority

Dear Sirs:

Our most recent examination of the financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries was as of December 31, 19X1, and for the year then ended which we reported on under date of February 15, 19X2. We have not examined any financial statements of the company as of any date or for any period subsequent to December 31, 19X1. Although we are presently performing certain procedures as part of our examination of the financial statements of the company as of December 31, 19X2, and for the year then ended, these procedures do not constitute all the procedures necessary in an examination made in accordance with generally accepted auditing standards or all the procedures necessary to make a study and evaluation of the company's system of internal accounting control as required by generally accepted auditing standards and rule 17a-5 of the Securities and Exchange Commission.

The management of Standard Stockbrokerage Co., Inc., is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with managements's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected.

Also, projection of any evaluation of the system of internal accounting control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the company's financial statements. It must be understood that the procedures performed would not necessarily disclose all material weaknesses in the system of internal accounting control and procedures for safeguarding securities.

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. (We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of rule 17a-11(f).)[1]

<u>Accounting Firm</u>

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[1]List and describe all items concerning which the independent auditor did not agree with the notification of the broker or dealer or concerning which the required notification was not made.

Independent Auditor's Report on Internal

Accounting Control Required by CEA

Regulation 1.16

To the Board of Directors of
Standard Stockbrokerage Co., Inc.

We have examined the financial statements of Standard Stockbrokerage Co., Inc., and Subsidiaries for the year ended December 31, 19X1, and have issued our report thereon dated February 15, 19X2. As part of our examination, we made a study and evaluation of the Company's system of internal accounting control (which includes the procedures for safeguarding customer and firm assets) to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. The purpose of our study and evaluation, which included obtaining an understanding of the accounting system, was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the financial statements.

Also, as required by Regulation 1.16(d) of the Commodities Futures Trading Commission, we have made a study of the practices and procedures followed by Standard Stockbrokerage Co., Inc., that we considered relevant to the objectives stated in Regulation 1.16(d), in making (i) the periodic computations of minimum financial requirements pursuant to Regulation 1.17 and (ii) daily computations of the segregation requirements of Section 4d(2) of the Act and the regulations thereunder, and the segregation of funds based upon such computations.

The management of the Company is responsible for establishing and maintaining a system of internal accounting control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above-mentioned objectives. The objectives of a system and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Regulation 1.16(d)(2) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal accounting control procedures or the practices and procedures referred to above, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the degree of compliance with them may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of Standard Stockbrokerage Co., Inc. taken as a whole. However, our study and evaluation disclosed no condition that we believed to be a material weakness.*

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives [except for the following conditions that we believe are material inadequacies in the practices and procedures comprehended in the Commission's objectives].**

This report is intended solely for the use of management and the Commodity Futures Trading Commission (specify any other regulatory body) and should not be used for any other purpose.***

Accounting Firm

New York, New York
February 15, 19X2

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*See note 5 on page 117-118.

**See note 6 on page 118.

***See note 7 on page 118.

EXHIBIT L

Representation Letter

February 15, 19X2

Accounting Firm

Gentlemen:

In connection with your examination of the consolidated statements of financial condition as of December 31, 19X1, and the related statements of income, stockholders' equity and changes in financial position of Standard Stockbrokerage Co., Inc., and Subsidiaries as of December 31, 19X1, and for the year then ended, for the purpose of expressing an opinion as to whether the consolidated financial statements present fairly the financial position, results of operations, and changes in financial position of Standard Stockbrokerage Co., Inc., and Subsidiaries in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your examination.*

1. We are responsible for the fair presentation in the consolidated financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

2. We have made available to you all--

    a. Financial records and related data.

    b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no--

    a. Irregularities involving management or employees who have significant roles in the system of internal accounting control.

    b. Irregularities involving other employees that could have a material effect on the financial statements.

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*As provided in paragraph 5 of SAS no. 19, "Client Representations," a paragraph might be added to state that management's representations pertain to items which exceed, individually or collectively, a stated materiality limit. Such a paragraph should indicate that the limitation does not apply to items 1, 2, 3a and 3b.

Accounting Firm
February 15, 19X2

c. Communications from regulatory agencies concerning non-compliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:

   a. Related party transactions and related amounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

   b. Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions or other requirements.

   c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements.

   d. Agreements to repurchase assets previously sold.

6. There are no--

   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards no. 5.

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards no. 5.

8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

9. Customers' debit balances, brokers' debit balances, and other accounts receivable are valid receivables. In our opinion, an adequate reserve has been established to cover any losses that may be incurred upon collection.

10. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

Accounting Firm
February 15, 19X2

11. Provision has been made for any material loss to be sustained in the fulfillment of, or from inability to fulfill, any purchase or sales commitments.

12. There are no securities or investments not readily marketable owned by the company or borrowed under subordination agreements except as disclosed in the financial statements or notes thereto (or as follows):

    It is understood that the term "securities and investments not readily marketable" shall include, but not be limited to, (a) securities for which there is no market on a securities exchange or independent publicly quoted market, (b) securities which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as regulation A, under section 3(B) of such act have been complied with--that is, "restricted stock") and (c) securities and investments which cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities and investments or to the company--that is, "control stock."

13. In addition, the company at December 31, 19X1, had:

    a. All securities exchange memberships recorded on the books.

    b. All participation in joint accounts carried by others properly recorded.

    c. No material unrecorded assets or contingent assets (such as claims relating to buy-ins, unfulfilled contracts, and so forth, whose value depends on fulfillment of conditions regarded as uncertain).

    d. No open contractual commitments other than those appearing on the memo books and records (for when distributed and delayed delivery contracts, underwritings and when issued contracts, endorsements or puts and calls, and commitments in foreign currencies and spot (cash) commodity contracts).

    e. Established a reserve for dividends and transfer items and security differences that is adequate to cover any anticipated losses in connection with the short securities that may have to be covered and/or claims arising from the liquidation of long securities.

    f. No borrowings or claims which were unconditionally subordinated to all claims or general creditors pursuant to a written agreement except as disclosed in the financial statements or notes thereto.

14. All liabilities subordinated to the claims of general creditors are covered by satisfactory subordination agreements under rule 15c3-1 and approved by (examining authority).

Accounting Firm
February 15, 19X2

15. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of non-compliance.

16. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

17. There are no capital withdrawals anticipated within the next six months other than as disclosed in the financial statements or notes thereto.

18. There are no material inadequacies at December 31, 19X1, or during the period January 1, 19X2 to February 15, 19X2, in the accounting system, the internal accounting controls, the procedures for safeguarding securities, and the practices and procedures followed:

    a. in making the periodic computations of aggregate indebtedness and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e);

    b. in making the quarterly securities examinations, counts, verifications, and comparisons and the reconciliation of differences required by rule 17a-13;

    c. in complying with the requirement for prompt payment for securities under section 4(c) of regulation T of the Board of Governors of the Federal Reserve System;

    d. in obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3;

    e. in making periodic computations of the minimum financial requirements pursuant to regulation 1.17 of the Commodity Exchange Act; and

    f. in making daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based upon such computations.

Net capital computation, prepared by the company during the period from January 1, 19X2, through February 15, 19X2, indicated that the company was in compliance with the requirements of rule 15c3-1 (and applicable exchange requirements) at all times during the period. Reserve calculations under rule 15c3-3 during the period did not reveal any deposit requirements that were not made on a timely basis.

Accounting Firm
February 15, 19X2

There was no computation of segregation requirements under the Commodity Exchange Act which indicated an insufficiency in segregation.

Yours very truly,

STANDARD STOCKBROKERAGE CO., INC.

Chief Financial Officer

Chief Executive Officer

NOTE: The above representations are illustrative and not necessarily all-inclusive. In addition, for partnerships, representations should be obtained with respect to the appropriateness of agreements providing for the inclusion of partners' individual accounts as partnership property in the financial statements and for the purpose of computing net capital.

GLOSSARY

GENERAL TERMS

account executive. See registered representative.

active box. A position on the stock record (street side) indicating securities located in the cashier's department that are normally available to the broker or dealer for its general use.

adequately collateralized. Indebtedness for which the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks regularly making comparable loans to brokers or dealers in the community.

ADR. Abbreviation for American depository receipt. A certificate issued by an American bank that serves as evidence of ownership of original foreign shares. These certificates are transferable and can be traded. The original foreign stock certificates are deposited with a foreign branch or correspondent bank of the issuing American bank.

aggregate indebtedness. The total of certain liabilities of a broker or dealer which are set forth in rule 15c3-1 of the Securities and Exchange Commission. The rule states that a broker or dealer shall not permit its aggregate indebtedness to exceed a specified percentage of its net worth as defined in the rule.

allied member. Any general partner or qualified voting stockholder of a member organization who is not himself a member of a stock exchange.

Amex. Popular name for the American Stock Exchange.

arbitrage. The act of buying a security in one market and selling it in another. Also, buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion or reorganization.

asked. A potential seller's lowest acceptable price for a security.

back office. The administrative area of a brokerage office, containing the bookkeeping, margin, purchase and sales (P & S), cashier's and dividend departments.

bad delivery. A delivery of securities that does not fulfill the requirements for delivery.

balance order. The net balance instructions, issued by a clearing corporation, to receive or deliver securities. The instructions give all the information needed by the member firm to clear its transactions on a given settlement date.

best efforts. Refers to an agreement by an underwriter to buy from the issuing corporation only those securities which it is able to sell to the public.

bid. The highest declared price a buyer is willing to pay for a security at a particular time.

Big Board. Popular name for the New York Stock Exchange.

block trading. The acquisition or disposition of large quantities (10,000 shares or more) or "blocks" of stock by a broker or dealer in order to facilitate the execution of buy and sell orders of customers, usually institutions. Often a broker or dealer absorbs a portion of the order for its own account and risk in order to avoid market disruption.

blotter. A record of original entry. A book or individual unit used as a record of original entry to record transactions as they occur. Covers purchases, sales, cash receipts and disbursements, and securities received and delivered.

Board broker. The broker on the floor of the Chicago Board Options Exchange (CBOE) whose duties are similar to those of a specialist on a registered national stock exchange.

board room. Popular name for the area in a broker's or dealer's office where customers can see postings of security prices and activity and enter orders for the purchase and sale of securities.

books closed. The cutoff time that determines stockholders of record for a prescribed period. Any entries affecting the registration or ownership of securities for dividend disbursements or proxy purposes must be made before this time.

borrowed. The act of borrowing a security for delivery. The equivalent value in money is usually deposited with the lender.

box. A "short" position in the stock record representing securities on hand in the possession of the broker or dealer. A place where securities are kept such as a vault, file cabinet, and so forth. "Boxes" are also identified as "safekeeping box," "segregation box," "name-of box," "active box," and so forth.

box count. An actual count of the securities in the box either in connection with an audit or with periodic checking.

broker loans. Money borrowed by brokers from banks.

brokers transfer account. An account kept by the transfer clerk of a broker or dealer giving details of securities transferred for the account of other brokers or dealers. The account arises when delivery is made by transfer as directed (TAD) instead of by delivery of the actual certificates.

bulk segregation. Securities (usually constituting excess collateral in margin accounts) which are filed in alphabetical order in special boxes in the vault but which are not specifically identified by owner. The securities are usually in the name of the broker or dealer, who maintains collateral records that indicate the owners.

buy-in. The procedure followed by a broker or dealer desiring to settle a buy contract which is past due. The broker or dealer may file with a stock exchange or the National Association of Security Dealers, Inc., as appropriate, a notice termed a "buy-in." A copy of the notice is also served on the broker or dealer from whom the securities were to be received. If the securities are not delivered, the stock or bond may be bought in for cash for the account of the broker or dealer who is to be received. The difference in price between the buy-in and the contract price is adjusted by check from one broker or dealer to another.

buying power. The equity remaining in a margin account after providing for the margining of existing securities in the account in accordance with federal and "house" margin requirements.

cage. The term given to the area of the broker's or dealer's office where the cashier, stock clerk, loan clerk, transfer clerk, blotter clerk, and others have, as a part of their duties, responsibility for the receiving and delivering of securities.

call (margin). A request for a margin customer to put up additional collateral (cash or securities). Usually a written request.

call loan. A loan which has no definite maturity or rate of interest. The loan may be either "called" by the lender or paid off by the borrower at any time.

call option. A contract which entitles the holder to buy (call), entirely at his option, a specified number of shares of a particular stock at a specified price at any time until the stated expiration date of the contract. Such an option (which is always for a round lot amount and which is transferable) is bought in the expectation of a price rise above the contract price. If the price rise occurs, the purchaser will exercise the option. If the rise does not occur, he will let the option expire and will lose only the cost of the option. With the advent of registered national exchanges for option trading, there is now both a listed and over-the-counter (OTC) market in options. (During the existence of an OTC option, the exercise price and number of shares is adjusted on the ex-date for cash dividends, rights and stock dividends or splits.)

cash account. The account of a customer of a broker or dealer who purchases and sells securities strictly on a cash basis. No credit margin is allowed.

cash sale. A sale with the same trade and settlement dates. The selling broker or dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.

cash transaction. A transaction which is expected to clear within the time prescribed by regulation T of the Board of Governors of the Federal Reserve System.

cashier's department. A division of the operations department of a broker or dealer that handles securities and money that are received or delivered by the broker or dealer. (See cage.)

CBOE. Abbreviation for Chicago Board Options Exchange. A national securities exchange based in Chicago, which provides a continuous market for trading in put and call options. Various other exchanges such as the American, Pacific and Philadelphia, Baltimore and Washington exchanges also provide such markets.

CCS. Abbreviation for Central Certificate Service. A subsidiary of the Stock Clearing Corporation of the New York Stock Exchange and a depository for eligible securities to facilitate clearances between member organizations without the necessity of receiving or delivering actual certificates.

churning. The process of unnecessary purchases and sales in customers' accounts for the purpose of generating commissions.

clearance. The act of clearing securities between buyers and sellers; receipt or delivery of securities against payment.

clearing house. The central location for matching security transactions of members to enable the determination of minimum quantities to be received or delivered.

clearing member. A broker or dealer entitled to use the services of the clearing corporation.

clearing organization. Usually a broker or dealer which clears the transaction of another broker or dealer. (See correspondent.)

comparison. A formal notice that details the terms of the contract between brokers or dealers who are parties to non-exchange trades. If the details of the trade are correct, the comparison is stamped (acknowledged) and returned; if they are incorrect, the broker or dealer indicates the difference(s) and returns the comparison. (See D.K.)

compliance department. The department of a broker or dealer that enforces adherence to policies established by the broker or dealer plus all rules and regulations fixed by the various regulatory agencies.

confirmation. Sets forth the terms of a contract between a broker or dealer and its customer for the purchase or sale of securities. Details shown on a confirmation are trade date, settlement date, number of shares or par value of bonds, security description, contract price, commission, account number and type of account, customer's name and address, and any other information required.

contract difference. The difference between the contract and the market values of commodities.

contract sheet. A listing of compared and uncompared transactions sent to each member firm by a stock clearing corporation.

conversion account. An account carried by a New York Stock Exchange member who endorses put and call options for a put and call dealer under a completely hedged condition. (Since the advent of listed options, this type of transaction occurs infrequently.)

correspondent. One of the parties to an agreement between two brokers or dealers that perform services for each other, such as the execution and the clearance of trades. A New York City broker or dealer (a clearing member) is usually the correspondent for an out-of-town broker or dealer (often a non-member).

cover value. The amount necessary to buy-in a "short" security position at the current market value.

credit department. See margin department.

current market value. As used in connection with margin trading, generally means the closing price of a security as of the preceding business day.

CUSIP (number). A means of uniformly describing and identifying specific security issues in numeric form. Developed by the Committee on Uniform Security Identification Procedure.

customers' man. A salesman or registered representative.

DAP. Abbreviation for delivery against payment. Also referred to as COD (cash on delivery), POD (payment on delivery), and DVP (delivery versus payment).

day loan. A loan made for only one day for the convenience of the broker or dealer. Generally on an unsecured basis.

dealer. A person or firm acting as a principal rather than as an agent in the purchase and sale of securities.

definitive certificates. Actual and permanent certificates of bonds or stock given in exchange for temporary receipts. These temporary receipts are usually issued at the time of a new offering before the engraved certificates are available.

delayed delivery. A transaction, the delivery of which is longer than the usual regular-way transaction. (See sellers' option.)

directed sale. Sale by the manager of a syndicate to a customer (usually an institution) of a syndicate member.

discretionary account. An account over which a broker or dealer or some other person has been given discretion by the customer as to purchases and sales of securities, including the kind of securities, as well as the time when and the prices to be paid or received. The discretion may be complete or limited.

distribution. The sale of a large block of securities to the investing public.

divided liability. Liability in a syndicate or underwriting which is fixed or definite in amount. (See undivided liability.)

dividend department. A division of the operations department that is charged with the collection of dividends and the crediting of these dividends to the accounts of customers.

D.K. Abbreviation for don't know. An expression used by a broker or dealer to indicate that a certain transaction which another broker or dealer is attempting to confirm or compare is unknown to it. When mutual understanding is reached, the transaction is properly compared or cancelled.

DTC. Abbreviation for Depository Trust Company. A depository for eligible securities which facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates.

due bill. A document passed between brokers or dealers stating that dividends, rights to subscribe, stock dividends, and so forth, are the property of the holder of the due bill.

equity. The net worth in an account carried by a broker or dealer, computed by subtracting the total of the "short" security values and the debit balance from the total of the "long" security values and the credit balance. If the result is a net credit, the account is said to liquidate to an equity.

equity securities. Term applied to common stocks or to debentures or preferred stocks which are convertible into common stocks.

equity statement (runs). Statements showing details of an account together with security valuations.

ex-clearing house. Transactions which are not settled through the clearing house.

ex-dividend. Synonym for "without dividend." The buyer of a stock selling ex-dividend does not receive the recently declared dividend. Open buy and sell stop orders, and sell stop limit orders in a stock on the ex-dividend date are ordinarily reduced by the value of the particular dividend. In the case of open stop limit orders to sell, both the stop price and the limit price are reduced. Every dividend is payable on a fixed date to all shareholders recorded on the books of the disbursing company as of a previous date of record. For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Since five business days are allowed for delivery of the security "regular-way" in transactions on a stock exchange, the exchange would declare the stock "ex-dividend" as of the opening of the market on the preceding Monday. This means that anyone buying the stock on and after Monday would not be entitled to the dividend.

ex-rights. Same as ex-dividend. The buyer of stock selling "ex-rights" is not entitled to the rights distribution.

ex-warrants. On occasion, stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. When these warrants are detached the security is traded "ex-warrants."

exchange tickets. The tickets (usually data processing cards) in a clearing corporation format, prepared by a broker or dealer for each transaction made on an exchange. These tickets list all pertinent details of the trade and are sent along with a daily summary listing to the clearing corporation for comparison and confirmation.

execution report. A confirmation notice of the completion of a trade that is sent from the floor of an exchange (for listed securities) or trading desk (for over-the-counter securities) back to the point of origin of the order.

exempt securities. Securities exempted from registration under the Securities Exchange Act of 1934, rather than by action of the Securities and Exchange Commission.

extension. Permission to extend credit beyond the time prescribed by regulation T of the Board of Governors of the Federal Reserve System.

fail-to-deliver. Securities which the selling broker or dealer has not delivered to the purchasing broker or dealer as of the settlement or clearance date.

fail-to-receive. Securities which the purchasing broker or dealer has not yet received from the selling broker or dealer at the settlement or clearance date.

fails. Uncompleted security transactions between two brokers or dealers. (See fail-to-deliver and fail-to-receive.)

firm account. An account consisting of securities in which the broker or dealer has taken a position for investment purposes, is making a market (principal wholesaler), or has an interest with another party (joint account).

firm commitment. Refers to the agreement of an underwriter to buy the entire issue of a security from the issuing corporation at a specified price.

firm price. The price at which a security can be bought or sold in the over-the-counter market for such period of time as the seller may specify.

flat. A method of trading in certain kinds of bonds. Usually used in trading income bonds which do not pay interest unless it has been earned and declared payable, or in bonds on which the issuing corporation has defaulted in the payment of interest. When bonds are traded "flat" the seller is not entitled to receive in addition to the price of the bond the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded "flat" must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuing corporation in the future.

flat statement. A statement with no money or security balance.

floor. Popular name for the area where securities are bought or sold on an exchange.

floor broker. Member of exchange who executes transactions on the exchange for the account of his own organization or for the account of other member organizations.

floor brokerage. The commission charged by one broker or dealer to another for executions of transactions on exchanges.

floor clerk. An employee of a broker or dealer who maintains a liaison between the order room and the floor broker.

floor report. A report of an executed trade given to the floor clerk by the floor broker which contains the number of shares, the price and the other broker on the trade.

FOCUS. Abbreviation for financial and operational combined uniform single report. The uniform regulatory report (Form X-17A-5) filed periodically by all brokers or dealers pursuant to rule 17A-5 of the Securities and Exchange Commission.

free securities. Securities which are fully paid for.

free shipment. Shipments of securities usually to out-of-town brokers or dealers without draft attached in order to avoid payment of collection charges.

fully paid accounts. Customer accounts in which the contract price to purchase securities has been paid. These securities should be "locked-up" in the segregation or safekeeping box.

give-up. Type of order which is given by a customer to a member firm on whose books the customer does not have an account.

good delivery. Certain basic qualifications must be met before a security sold may be delivered. The security must be in proper form to comply with the contract of sale and to transfer title by delivery to the purchaser.

good-faith deposit. Deposit to guarantee performance, usually with respect to new issues of securities.

group account. A syndicate or joint account.

GTC. Abbreviation for good 'til cancelled. Also called an "open order." When this term appears on an order to buy or sell a security, it means that the order is to remain in effect until it is either executed or cancelled.

haircut. Deductions from "net worth" of certain specified percentages of the market value of securities and future commodity contracts "long" and "short" in the capital and proprietary accounts of a broker or dealer, and in the accounts of partners. These deductions are solely for the purpose of computing "net capital" and are not entered on the books.

holder-of-record. The party listed as the registered owner on the transfer records of a corporation.

holders' file. A subsidiary file (punched cards, discs, or tapes) in account sequence showing securities owned or carried in such accounts.

house account. An account used by a broker or dealer to maintain a trading and/or investment position in a security for itself or its officers or partners. Also a name given to a customer's account to which no registered representative has been assigned.

house rules. Rules promulgated by the broker or dealer. Usually refers to the maintenance margin required by the broker or dealer which is over and above the requirements of governing bodies.

hypothecation agreement. An agreement signed by a customer that permits his broker to use securities in the customer's margin account as collateral for loans made to the broker.

in-box sheet. Sheet that includes a list of items going into the box.

in-house. Within the broker's or dealer's firm.

initial margin. The amount of money or its equivalent specified by the Board of Governors of the Federal Reserve System that a customer must deposit with his broker when the customer buys a security on margin.

international arbitrage. Same as arbitrage, except the markets are in different countries.

investment banker. One who underwrites securities on an initial or secondary basis. This type of underwriting often involves private placements where the investment banker may act as both a broker and/or a dealer.

joint account. An account in which two or more persons have an interest.

legal list. A list of securities in which insurance companies, banks, and fiduciaries are permitted by law to invest.

legal transfer. A stock certificate having an assignment executed by an executor, administrator, trustee, guardian, and so forth, and requiring certain legal documents indicating the authority of the party assigning the securities.

letters-of-credit. An unqualified commitment issued by banks or trust companies to pay a specified sum of money immediately upon demand at any time prior to the expiration of the "letter-of-credit." Most commonly used by brokers or dealers to satisfy margin requirements at the Options Clearing Corporation or commodity clearing organizations.

limit order. Also called a "limited order" or "limited price order." An order to buy or sell a security at a price specified by the customer or at a better price if such price can be obtained.

listed security. A security which is traded on an exchange.

loan consent. An agreement signed by a customer that permits the broker or dealer to lend securities in a margin account to other brokers or dealers.

loan value. The value at which a security is accepted for margin. This value is usually less than or at a discount from current market value.

loaned. The act of lending a security usually for delivery against a "short" sale. The equivalent value in money is usually deposited by the borrower. Opposite of borrowed.

lock-up. The act of placing securities in safekeeping or segregation.

long. Denotes ownership of securities. Due to.

long and short record. See stock record.

maintenance margin. The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules.

margin. The equity in an account. The requirements as to the amount of margin vary between initial margin and maintenance margin and also according to the type of collateral used in computing the equity.

margin call. A request for additional margin.

margin department. A division of the operations department. Its function is to keep an up-to-date record of each customer's purchases and sales of securities and to carefully watch margin transactions in a customer's margin account.

margin transaction. A transaction on which the broker or dealer advances credit to the customer for a portion of the purchase price.

mark-to-market. A procedure whereby a broker or dealer has the right to demand that the price of a past due or open contract be adjusted to current values by the advancement of additional funds.

mark-up. Refers to the difference between what a dealer has paid for a security and the price at which it offers the security to another person.

market maker. A broker or dealer that stands ready to buy or sell a particular security in the over-the-counter market at prices which the broker or dealer has quoted. Also, an options trader on the floor of a registered exchange who stands ready to buy or sell a particular option.

market price. Usually means the last reported price at which a security has been sold.

master file. A file which contains the official account numbers and descriptions of securities or customers' names and addresses.

maximum loan value. Refers to the percentage of the purchase price of a security which the broker or dealer may lend to a customer who is buying a security on margin.

member corporation. A broker or dealer that is organized as a corporation and that has at least one director-holder of voting stock who is a member of an organized stock exchange.

member firm. A broker or dealer that is organized as a partnership and that has at least one general partner who is a member of an organized stock exchange.

mixed account. An account which contains both "long" and "short" securities.

Municipal Securities Rulemaking Board. Agency established by Congress to establish rules for brokers and dealers effecting transactions in obligations of, or guaranteed by, state or local governments or any political subdivision, agency, or instrumentality thereof.

NASDAQ. An electronic quotation system for the over-the-counter market sponsored by the National Association of Securities Dealers, Inc.

name-of securities. Securities registered in the name of customers of the broker or dealer.

NASD. Abbreviation for National Association of Securities Dealers, Inc. An association of brokers and dealers who do business in the over-the-counter market. The association supervises and regulates the trading conduct of its members.

net capital. Net worth of a broker or dealer less certain items such as exchange memberships, carrying value of securities which are not readily marketable, "haircuts" on marketable securities in proprietary accounts, furniture and equipment, and so forth, as defined in the net capital rules.

new issue. A security that is sold by an issuing corporation for the first time.

odd lot. A quantity of securities which is less than the trading unit, usually a quantity less than an even 100 shares.

odd-lot broker. A broker who executes odd-lot transactions for other brokers. Such brokers buy or sell round lots on the exchange to cover the odd-lot transactions.

odd-lot differential. The fraction which is added to or deducted from the round lot price by the odd-lot broker.

off-board. Trading in unlisted securities in the over-the-counter market. Also used to describe transactions in listed securities not executed on a stock exchange.

offer. The lowest price at which a seller is willing to sell a security.

omnibus account. An open account carried and cleared by another broker or dealer containing accounts of undisclosed customers on a commingled basis which are carried individually on the books of the broker or dealer introducing the trade.

operations department. The name associated with the overall clerical functions of a broker or dealer. Sometimes referred to as the "back office."

optional dividend. A dividend that is payable in either stock or cash at the option of the holder of record.

order department. A division of the operations department that receives customers' orders and transmits them either to the floor of a stock exchange or to the trading department for execution. The order department also receives notices of executed trades and transmits such notices to the purchases and sales department and to the registered representatives.

order room. Another name for the order department.

out-of-box sheet. A sheet listing securities removed from the box.

over-delivery. Delivering a greater amount of securities than called for, the surplus amount being returned by transferring it to the name of the delivering broker or dealer.

OTC. Abbreviation for over-the-counter. A market for securities made up of brokers or dealers who may or may not be members of a securities exchange. Over-the-counter is mainly a market made over the telephone. Thousands of companies have insufficient shares outstanding, stockholders or earnings to warrant application for listing on a stock exchange. Securities of these and other companies are traded in the over-the-counter market between brokers and dealers who act as either principals or brokers for customers. The over-the-counter market is the principal market for U.S. government bonds and municipal securities.

over-the-window. The direct delivery of securities between two brokerage concerns, excluding the clearing-house facilities. Delivery is made by hand to the receive window of the broker and is said to be "over-the-window."

pair off. When two brokers or dealers each owe one another the same number of shares of the same security. Instead of actually receiving the security and delivering it back again, they will "pair off" the transaction by giving or receiving a check for the difference in price, or by exchanging checks for the full amount of each side of the transaction.

papers. A term sometimes given to put and call options.

payable date. The date on which a dividend is payable to holders of record as of some previous date.

P.E. Abbreviation for price-earnings ratio. The market value of a share of stock divided by its earnings per share.

pink sheets. A listing of over-the-counter securities published on pink paper by the National Quotation Bureau. It shows the most recent bid and asked prices for the securities listed, as well as the brokers and dealers making a market in those securities. While pink paper is used for stock quotations, the definition also applies to listings of bond quotations, and so forth, which are printed on papers of different color.

point. When used in connection with the purchase or sale of stocks, "point" means a rise or decline of $1.00 per share. When used in connection with the purchase or sale of bonds, it means a rise or decline of $10.00 per $1,000 principal amount.

point balance run. A listing of each future commodities contract by month of contract on which the extended contract value and market value are indicated, together with the resulting gain or loss.

puts and calls. Options to sell (put) or buy (call) securities within a specified period of time at specified prices. (See put option, call option, straddle, strip, and strap.)

put option. A contract which entitles the holder to sell (put), entirely at his option, a specified number of shares of a particular security at a specified price anytime until the stated expiration date of the contract. Such an option (which is always for a round-lot amount and which is transferable) is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise the option. If the decline does not occur, he will let the option expire and will lose only the cost of the option. With the advent of registered national exchanges for option trading there is now, or will be, both listed and over-the-counter markets in options. (During the existence of an over-the-counter option the exercise price and number of shares are adjusted on the ex-date for cash dividends, rights and stock dividends or splits.)

quote. The price of a security. It may be the price of the last sale made on an exchange or the current bid and asked price.

receive-and-deliver department. A division of the operations department responsible for the physical receipts and/or delivery of incoming and outgoing securities. Often it is also responsible for the daily balancing of cash entries made by the various operations departments.

record date. The date on which the stockholder's name must be registered on the books of a company in order to receive a declared dividend or, among other things, to vote on company affairs.

registered owner. The owner of a security whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

registered representative. Name given to a salesman of the broker or dealer. Salesmen are registered with the exchange of which the broker or dealer is a member.

registered trader. Individuals or entities who have obtained approval to trade for their own account on the floor of a national securities exchange. Such individuals or entities have certain obligations with regard to stabilization of the market in securities for which they are registered. They also have less stringent financial responsibilities and reporting requirements than full service brokers or dealers.

registrar. Usually a trust company or bank charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.

regular-way delivery. Unless otherwise specified, securities (other than those of the U.S. government) are to be delivered to the buying broker or dealer by the selling broker or dealer, and payments are to be made on the fifth business day after the transaction. The regular-way delivery day for government bonds is the business day following the transaction.

regulation G. The Federal Reserve Board's regulation governing the amount of credit that persons other than banks or brokers or dealers may extend to investors who borrow money to buy securities on margin.

regulation T. The name for the Federal Reserve Board's regulation governing the amount of credit that brokers and dealers may extend to customers who buy securities.

regulation U. The name for the Federal Reserve Board's regulation governing the amount of credit that banks may extend to customers who borrow money to buy securities on margin.

regulation X. The Federal Reserve Board's regulation specifying conditions with which a borrower must comply when obtaining credit for the purpose of purchasing or carrying securities.

reorganization department. A division of the operations department that processes securities involving corporate reorganizations, mergers, consolidations, subscriptions, and the exchange of convertible securities into common stocks.

repurchase agreement. An agreement whereby the seller of securities agrees to repurchase the securities within a specified time at a specified price.

restricted account. Means that a broker may not buy securities for a particular customer for a specified period of time unless the customer has deposited enough money in his account to pay for the securities before his orders are executed.

rights. The privilege offered by a corporation to its stockholders to subscribe to certain securities at an advantageous price.

round lot. A unit of trading or a multiple thereof. On the New York Stock Exchange the unit of trading is generally 100 shares in stocks and $1,000 par value in bonds.

round turn. A purchase and a subsequent sale or a sale and subsequent purchase of a commodity futures contract.

safekeeping. A position on the stock record (street side) indicating securities that have been fully paid for by customers and that are being held by the broker or dealer under custody arrangements. These securities are generally in the name of the customer.

safekeeping box. Box in which customers' fully paid for securities are kept.

SCA. Abbreviation for subsequent coupons attached.

scrip. A certificate issued to stockholders of a corporation which may be exchanged for fractional shares of stock or the equivalent in cash by a fixed date. "Scrip" is usually issued in connection with a stock dividend or a stock split.

seat. Popular name for a membership on a stock exchange.

secondary distribution. The sale of a large block of securities (other than an initial issue of a corporation). It is usually the holdings of a large individual stockholder or an estate which are being liquidated.

secondary offering. An offering of large blocks of listed securities outside of the exchange on which they are listed.

SEC. Abbreviation for Securities and Exchange Commission. An agency established by Congress to administer federal securities laws.

securities borrowed. See borrowed.

securities bought but not received. A liability account used by brokers or dealers that act principally as underwriters or dealers to record purchases as of the trade date rather than the settlement date.

securities loaned. See loaned.

securities not readily marketable. This term refers to (a) securities, except exempted securities, for which there is no market on a securities exchange or no independent publicly quoted market; (b) securities which cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as regulation A under section 3(b) of such act have been complied with); and (c) securities which cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or the broker or dealer.

securities sold but not delivered. An asset account used by brokers or dealers who act principally as underwriters or dealers to record the sales of securities as of the trade date rather than the settlement date.

segregation. A position on the stock record (street side) indicating customers' fully paid for or excess margin securities which are subject to the customers' instructions and which have been set aside. These securities are generally in the name of the broker or dealer. (See bulk segregation.)

segregation box. Box in which segregated securities are kept.

sell out. Action taken by a broker or dealer to liquidate an account or transaction for failure to maintain proper margin or make timely payment.

seller's option. Transaction which by agreement is to be settled at a date later than the usual regular-way transaction.

selling against the box. This is similar to a "short sale" except that the seller already owns the stock being sold but keeps possession of it and so has to borrow the equivalent stock with which to make delivery to the purchaser.

selling group. A group of brokers or dealers that have formed a joint account for the sale of securities, usually in connection with an underwriting.

service bureau. A data processing center which processes the transactions of brokers or dealers. These centers are located away from the broker's or dealer's office.

settlement date. The date on which security transactions are to be settled by the delivery or receipt of securities and the receipt or payment of cash.

settlement price. The price at which a security or commodity is to be settled. Used primarily in connection with clearing house operations.

short. A stock record position (street side) which represents location (such as box, transfer, and so forth) or due from (such as failed-to-receive, owed to the brokerage concern by a customer on account of a short sale, and so forth).

short against box. See selling against the box.

short covering. Refers to the purchase of securities so that stock previously borrowed to make delivery on a "short" sale may be returned.

short sale. A sale of securities by a customer which requires the borrowing of equivalent securities to make delivery to the purchaser.

SIAC. Abbreviation for Securities Industry Automation Corporation. The servicing agent of the New York and American Stock Exchanges, which is responsible for all data processing relating to trade comparison and settlement on a continuous net settlement basis.

signature guaranteed. In order that a registered security may be a good delivery on the exchange or a good transfer, the signature of the registered owner must be properly guaranteed. The guarantee of a stock exchange member or a bank is usually considered sufficient guarantee.

SIPC. Abbreviation for Securities Investor Protection Corporation. A corporation established for the purpose of protecting customers of brokers or dealers in financial difficulty.

special offering. The sale of a large block of securities on the floor of the stock exchange. The sale is made in accordance with special procedures worked out by officials of the exchange.

specialist. A broker who is a member of an exchange and who operates on the floor of the exchange to execute transactions and to maintain an orderly market in certain specified securities.

split. The action of increasing the number of outstanding shares of stock of a company so as to decrease the market price and afford a greater distribution of the shares. For example, two shares for each share held will have the effect of reducing the price of the shares by one-half.

spread. A combination of a put and call option at different prices--one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security.

stock dividend. A dividend payable in stock of the issuing corporation.

stock power. A legal document used in lieu of the assignment section of a stock certificate. It cannot be used on a bond certificate.

stock record. The record of individual securities on which both the "long" and "short" positions are shown, the total of the "long" positions and the total of the "short" positions being in balance.

stock record department. A division of the operations department that keeps up-to-date records of all securities positions.

stock split. A method used by corporations to increase the number of shares of its stock outstanding but without changing each stockholder's interest in the corporation. Usually accomplished by reducing the par value, or stated value, of the stock.

stockholder of record. A stockholder whose name is registered on the books of the issuing corporation.

stop order. Also called a stop loss order. An order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order when the price of the security reaches, or sells through, the price specified by the customer.

straddle. A combination of one put and one call, identical with respect to the security issue, number of shares, exercise price, and expiration date.

strap. A combination of two calls and one put for the same security issue.

street. A term of reference for brokers or dealers and other financial business concerns.

street item. A transaction or account between brokers or dealers (for example, "failed-to-receive," "failed-to-deliver," "stock loaned," and "stock borrowed").

street name. Securities held in the name of a broker or dealer instead of in customers' names are said to be carried in "street name."

strip. A combination of two puts and one call for the same security issue.

subordinated account. An account which is subordinated to the claims of general creditors of the broker or dealer.

subscription. The offer to purchase a certain offering as a certain number of shares of the stipulated stock or principal amount of bonds for a stipulated amount of money. The offer is not binding unless accepted by the proper authorized representatives of the issuing corporation.

substitution. The act of withdrawing securities from a bank loan and substituting other securities of approximate equal value.

suspense account. An account used to record securities and/or monies that cannot be immediately identified and cleared (for example, reclamations, D.K. items, and bad deliveries).

syndicate. A group of brokers or dealers who together underwrite and distribute new issues of securities or large blocks of an outstanding issue.

TAD. An abbreviation of transfer as directed.

take-off. Sometimes referred to as a "daily activity list." A daily record showing the net changes in each security. A separate record is prepared for each security and the information is used to post (update) the stock record. Also, a record of the "long" and "short" positions in a security on the record date which is used by the dividend department to make the appropriate dividend entries.

tax stamp. A rubber stamp facsimile (in some instances a documentary stamp) affixed to a certificate to indicate that all applicable transfer taxes for the item have been paid.

ticker. An instrument that prints the price at which a security has been traded on an exchange within minutes after the trade has been executed.

time loan. A loan having a definite date of maturity and a specified rate of interest for the entire period.

trade. A term that indicates the consummation of a security transaction, either a purchase or a sale.

trade date. The date a security transaction is actually executed.

trader. An employee of a broker or dealer who executes orders in the over-the-counter market for customers. Also means a person who buys or sells securities for his own account for short-term profit.

trading post. Another name for post.

trading unit. The unit by which the security is traded on the exchange, usually 100 shares of stock or $1,000 principal amount of bonds (round lot).

transfer. Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.

transfer agent. A transfer agent keeps a record of the name of each registered shareholder, his or her address, and the number of shares owned. The agent sees that certificates presented to his office for transfer are properly cancelled and that new certificates are issued in the name of the transferee.

transfer department. A division of the operations department that matches, processes, and controls securities being transferred.

two-dollar broker. A name given to a member of an exchange who executes orders for other brokers on that exchange.

underwriting. The act of distributing a new issue of securities or a large block of issued securities--that is, a secondary offering.

undivided liability. An arrangement whereby each member of an underwriting syndicate is liable for his proportionate share of unsold securities in the underwriting account regardless of the number of securities which he has previously sold.

undue concentration. Additional "haircut" from net capital (see rule 15c3-1) on the market value of certain aged proprietary security positions of a single class or series of the same issuer which exceeds 10 percent of a broker's or dealer's net capital before "haircuts."

unit record. A term applied to a data processing system which utilizes only punch cards.

unlisted security. A security which is not listed on an exchange.

value date. Same as settlement date.

valued stock record. The stock record at examination date, with each security position other than those in segregation and safekeeping assigned a price. Active quantities within the position are valued at the assigned price.

variation margin. A term used in commodity operations. Refers to last-day point fluctuation--difference between the prior day's settling price and the last day's settling price--on net positions "long" and "short."

warrants. Rights to purchase additional securities. Usually affixed to the certificate at the time securities are originally issued. Also, a document evidencing rights. For example, a warrant for 125 rights.

when-distributed. Refers to the distribution of new securities. Transactions are sometimes entered into on a "when-distributed" basis before the distribution takes place.

when-issued. A short form of "when, as, and if issued." The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All "when-issued" transactions are on an "if" basis to be settled if and when the actual security is issued and the exchange or National Association of Security Dealers rules that the transactions are to be settled.

window. A term applied to a place in the office of a broker or dealer where securities are actually received or delivered.

window ticket. A term applied to a document given to the broker or dealer by a transfer agent as a receipt. Also applies to a transfer document originating with the brokerage concern (broker-originated window ticket).

wire house. A brokerage concern that has a network of communications (telephone or teletype) that links the main office to branch offices and offices of correspondent brokerage concerns.

wire room. See order room, order department.

yield. The return on investment that an investor will receive from dividends or interest. The return is expressed as a percentage of the current market price of the security; or, if the investor already owns the security, of the price he paid. The return on stocks is computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bid.

COMMODITY TERMS

CFTC. Abbreviation for Commodity Futures Trading Commission. An agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants (FCMs). Among other things, this agency establishes rules governing the minimum financial, reporting, and audit requirements of its members. Its function is similar to that performed by the Securities and Exchange Commission in regulating brokers or dealers in securities and various securities markets.

commodity hold out. Commodity transactions on the broker's or dealer's records that are not reported on the clearing house sheets.

commodity spreading. Implies open purchase ("long") and sale ("short") contracts in the same commodity or in different commodities.

futures contract. Contract for the purchase or sale of commodities at the same time in the future.

spot commodity. A contract for the future delivery of a commodity. In these cases the commodity is evidenced by a warehouse receipt.

fungibility. GNMAs are interchangeable as to interest rate and pool and are traded and settled at an equivalent yield basis.

future contracts. The sale or purchase of GNMAs on the Chicago Board of Trade at a future date. As in the case of normal commodity transactions where delivery is made with warehouse receipts, GNMA transactions are cleared with the delivery of due bills.

GNMA. Abbreviation for Government National Mortgage Association. GNMA modified pass-through certificates are bought and sold on a current or delayed settlement date basis.

interest trades. These transactions, as defined, involve (a) a purchase of GNMA securities for current settlement, (b) a delayed settlement sale of these securities or the possession of a long standby, and (c) a financing of the long GNMA position by a sale under an agreement to repurchase on or before the future delivery date.

optional commitment. A call exercisable at a future date. A long optional commitment is an option to purchase GNMA securities; a short optional commitment is an option to sell.

optional commitment fee. Amount received or paid for the sale or purchase of an optional commitment.

repurchase agreement (repo). Securities sold at the same time an agreement is entered into with the same party to resell the securities on a delayed settlement basis (basically a financing transaction).

reverse repurchase agreement (reverse repo). (Usually a U.S. Government obligation or corporate debt instrument.) The purchase of a security at a specified price with a simultaneous agreement to resell the security at a specified price on a specified future date. An agreed upon interest rate is earned by the purchaser-reseller over the life of the contract. For financial reporting purposes, the transaction is treated as a receivable collateralized by the security "bought," not as part of a broker's or dealer's trading and investment inventory.

standby. A put exercisable at a future date. A long standby is an option to sell GNMA securities; a short standby is a commitment to buy.

standby fee. Amount received or paid for the sale or purchase of a standby (approximately 1 percent to 1-1/2 percent of the principal amount).

striking price. The price at which GNMA securities can be purchased or sold upon the exercise of a standby or optional commitment.

TBA. Future GNMA pools "to be announced" which are bought and sold for future settlement. "To be announced" refers to interest rates and due dates which are determined at a later date; trading in these securities is done on a yield basis.

up-front fee. Amount of cash paid to a delayed settlement TBA or GNMA purchaser which is offset by an increase in the sales price.

SELECTED BIBLIOGRAPHY

(To be added to the final guide)